SIA

Foreign Activ

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An Analysis of Foreign Participation in the U.S. Securities Markets
Produced by the SIA Research Department

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Foreign Activity in U.S. Equities
January-September 1986

"A Record-Breaking Pace"

The Score Card

Third-quarter foreign activity in U.S. equities adds but another quarter of heightened activity to the already record-shattering pace of 1986. Through the first nine months of the year, foreign gross transactions totaled $203.6 billion, some 28% ahead of 1985's all-time high of $159.0 billion. Annualizing this pace, 1986 gross activity is estimated at $271.4 billion.

Record transaction levels have translated into record net foreign purchases of U.S. equities. For the first three quarters of 1986, foreign investors have made net purchases of $18.3 billion of equities -- an enthusiasm approximating over three times 1981's annual record of $5.8 billion.

Who's Buying?

Foreign investors in all major regions have escalated activity in U.S. equities from 1985. Net purchases in 1985 at $4.9 billion were the third largest in the 1980s. Nevertheless, 1986 activity has left previous annual and quarterly records in the dust from the first quarter of the year on. European investors, traditionally the largest buyers of U.S. equities, have made net purchases of $10.6 billion of equities in the first three quarters of 1986, compared with $2.1 billion in 1985. Almost half of European net purchases thus far in 1986 were from the U.K., with net purchases of $2.2 billion by Swiss investors the second largest from Europe.

Asian investors have been the second most enthusiastic supporters of U.S. equities, $4.2 billion, during the first nine months of 1986. Strong interest, particularly in the

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. EQUITIES
($ Millions)

	1986 First Quarter		1986 Second Quarter		1986 Third Quarter	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$33,494	$4,770	$38,455	$3,819	$34,551	$1,983
Belgium-Luxembourg	1,549	135	2,375	275	2,350	271
France	2,036	(156)	2,908	358	2,109	316
Germany	2,711	598	2,779	(25)	2,432	(166)
Netherlands	1,458	396	1,854	455	1,484	138
Switzerland	9,618	1,406	10,275	807	8,487	(83)
United Kingdom	14,861	2,269	16,316	1,329	16,224	1,462
Canada	7,469	139	9,658	223	8,100	402
Latin America & Caribbean	7,632	344	10,717	1,405	9,726	522
Bermuda	2,178	4	3,092	357	3,023	229
Netherlands Antilles	2,312	175	2,990	217	2,788	39
Asia	9,254	860	11,480	1,305	16,224	1,869
Hong Kong	1,431	41	1,909	91	2,252	68
Japan	3,402	348	4,105	849	9,573	1,395
"Other Asia"*	3,765	316	4,800	220	3,554	317
Total All Countries	$59,271	$6,361	$72,117	$7,027	$70,282	$4,692

Source: U.S. Treasury

* Countries included are: Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, the United Arab Emirates.

third quarter, from Japanese investors accounts for 62% of Asian net purchases. Canadian net purchases of $766 million are over two times the 1985 level, and Latin American and Caribbean investors have boosted net purchases by 33% to $2.3 billion from 1985.

What's the Attraction?

Focusing on two of the major factors in the decision of foreign investors to diversify into U.S. equities -- the U.S. dollar and stock market -- finds a mixed performance. In a relatively uninterrupted slide, the dollar has given up between 20%-30% against the German mark, Swiss franc and yen from the

end of December 1985 to the end of September 1986. Over the same period, the dollar has held steady against the pound and Canadian dollar. Moreover, measured by Morgan Stanley Capital International Perspective, 11 foreign markets beat the U.S. market in local currency terms and 15 beat the U.S. market in adjusted-for-dollar terms. Nevertheless, with the declining dollar making U.S. stocks "cheap" and many foreign exchanges rumored as overvalued, the U.S. market has drawn foreign funds like a magnet in 1986.

By Comparison

The magnitude of foreign activity in U.S. equities can be gauged by using several measuring sticks. First, assuming 80% to 85% of foreign gross activity in equities is transacted on the New York Stock Exchange, foreign activity is running 10.9% to 11.6% of the total public volume in the first nine months of 1986. This would represent a minimal uptick in proportion, as an explosion of domestic volume has coincided with an explosion in foreign volume.

Using SIA's Investor Activity Report data, we estimate that institutional net purchases for the first nine months of 1986 on the major markets were $29.3 billion. While the total $29.3 billion represents only secondary market transactions, we can assume that much of the $18.3 billion of foreign net purchases also represents secondary market activity. In other words, it appears foreign net purchases of U.S. equities could be as much as half that of all U.S. institutions.

And Vice Versa

U.S. investors have reciprocated foreign investors' enthusiasm in like kind. Gross U.S. activity in foreign stocks in the first nine months of 1986 has reached an impressive $72.4 billion, already 59% more than 1985's $45.6 billion. However, while net purchases in the first half of 1986, $4.2 billion, were headed for a record, net sales in the third quarter put net purchases in the first nine months at a smaller but still impressive $3.4 billion. This compares to 1985 when U.S. investors accumulated a record $3.9 billion of foreign stocks.

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Foreign Activity in U.S. Securities

"Highlights"

1. With the market setback of the third quarter came a slowdown in the record-shattering pace of foreign net purchases of U.S. equities. Third-quarter net purchases of $4.7 billion compare with the second-quarter all-time high of $7.0 billion. Nevertheless, for the first three quarters of 1986, foreign investors made net purchases of $18.3 billion of U.S. equities -- over three times 1981's annual record of $5.8 billion.

2. Gross foreign transactions in U.S. equities at $203.6 billion in the first three quarters of 1986 are running 28% ahead of 1985's record of $159.0 billion. Assuming 80%-85% of foreign gross activity is on the NYSE, this activity would represent 11%-12% of the value of public volume. This is a minimal uptick from previous years, as heightened foreign activity has corresponded with increased domestic activity.

3. As European investors scaled back net purchases of U.S. corporate bonds, Japanese investors doubled net purchases to $1.5 billion in the third quarter from $613 million in the second quarter. However, total foreign net purchases of corporate bonds fell 18% to $10.3 billion from $12.6 billion in the second quarter.

4. Japanese investors were major players in the Treasury market in the third quarter, making net purchases of $5.1 billion. Overall, foreign holdings of U.S. Treasuries increased by $5.6 billion to an estimated $163.5 billion in the third quarter.

5. U.S. investors reversed their investment posture toward foreign stocks in the third quarter, making net sales of $800 million. The first three quarters' net purchases, however, was a still-significant $3.4 billion. Over the same period, gross activity hit $72.4 billion, 59% higher than 1985's annual record of $45.6 billion.

Introduction

The foreign investor weighs an assortment of comparative economic and political factors in considering investment in U.S. equities. A focus on two of the main factors -- the U.S. dollar and stock market -- finds a mixed performance in 1986. However, the trend of foreign investment has closely paralleled the waxing of the stock market and all but dismissed the waning of the U.S. dollar. As the market climbed to heady heights in the first half of 1986, so too did foreign investment in U.S. equities. With the market setback of the third quarter came a slowdown in the record-shattering pace of foreign net purchases. Nevertheless, through September, foreign investors made net purchases of $18.3 billion of U.S. equities -- over three times 1981's annual record of $5.8 billion.

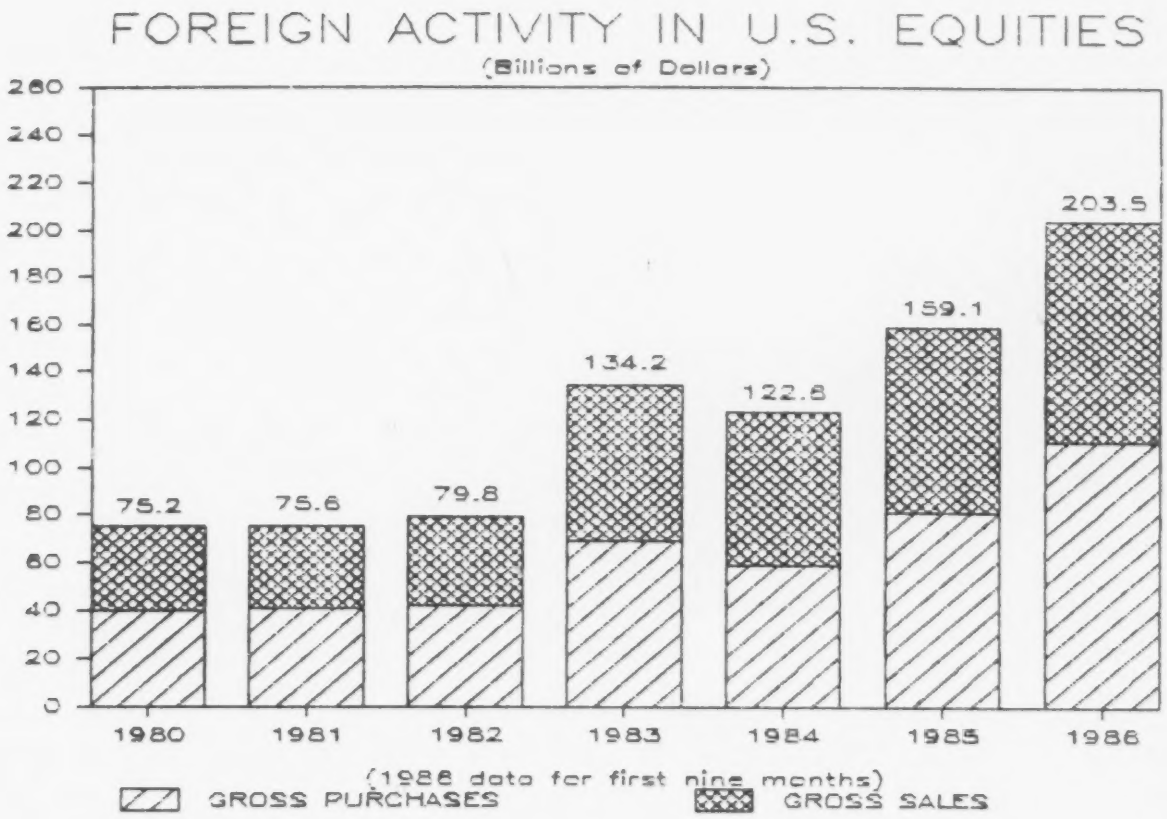
At the beginning of the third quarter, concerns mounted over the path of future growth of the U.S. economy. Indeed, revised second-quarter real GNP failed to reach a 1.0% annual rate. Much speculation ensued over interest rate cuts, both in the U.S. and certain foreign countries, as some policymakers called for more stimulatory policies to address global trade imbalances. The Federal Reserve cut the discount rate in two moves to 5.50% by the end of the quarter. Despite intense speculation, neither Germany nor Japan followed suit.

Disappointing second-quarter data was followed by signs that the third quarter would be brighter. Prospects of stronger growth, however, carried with it prospects of renewed inflationary pressures. Confusing economic signals coupled with the highlighting of international problems produced an uneven stock market performance in the third quarter. Although touching record highs, the market also took two of its record plunges and closed down for the period. From the end of June to the end of September, the DJI Average declined by over 6% and the S&P 500 and NYSE Composite indices fell by over 7%. Progress on most foreign stock exchanges also slowed during the third quarter.

With the exception of the pound and the Canadian dollar, the U.S. dollar continued to slide against most major foreign currencies in the third quarter. Declining oil-prices pressured the pound, which gave up 6% to the dollar, and the Canadian dollar wavered minimally. Both the German mark and Swiss franc appreciated by over 8% vis-a-vis the dollar, while the yen and French franc gained almost 6%.

Although the pace slackened in the third quarter, the magnitude of foreign activity in U.S. equities has been record

breaking (see Chart). The declining dollar paired with a rising stock market has sent net purchases and gross activity to new plateaus. While gross activity is likely to be maintained at the third-quarter level in the last quarter of the year, preliminary and confidential SIA data indicate that foreign investors lost much of their enthusiasm for acquiring U.S. equities during the fourth quarter.



Foreign Activity in U.S. Equities

Gross Activity

The exceptional activity of foreign investors in U.S. equities continued through the third quarter of 1986. Although third-quarter gross activity, $70.3 billion, represents a 3% dip from the second-quarter level, transactions total a dramatic $203.6 billion at the nine-month mark. Hence, 1986 first three quarters' activity is running 28% ahead of 1985's all-time high of $159.0 billion. To put the magnitude of this activity into perspective -- assuming 80%-85% of foreign gross transactions are on the NYSE, this would represent 11%-12% of the value of public volume. This is a minimal uptick from previous years, as heightened foreign activity has corresponded with greater domestic activity.

Investors in three major regions reduced gross activity in the third quarter. European investors cut back activity by 10% to $34.6 billion from $38.5 billion in the second quarter. Similarly, Canadian investors decreased gross transactions by 16% to $8.1 billion and Latin American and Caribbean investors, by 9% to $9.7 billion. Offsetting these reductions was a 41% spurt in activity from Asian investors to $16.2 billion from $11.5 billion in the second quarter. Japanese investors propelled the increase, stepping up gross activity to $9.6 billion -- more than double the second quarter's pace.

Net Purchases

The record-breaking clip of foreign gross activity has been matched by a record-breaking level of net purchases. For the first nine months of 1986, foreign net purchases of U.S. equities were a substantial $18.3 billion. By comparison, using data in SIA's Investor Activity Report, U.S. institutions made net purchases of an estimated $29.3 billion on the major stock markets. While all of this institutional activity is in the secondary market, we can assume that most of foreign activity is also. Hence, foreign net purchases of U.S. equities could be as much as half that of all U.S. institutions.

Coinciding with the modest slack in gross activity from the second to third quarter was a more substantial drop in the level of net purchases. Net purchases fell 33% in the third quarter to a still significant $4.7 billion from an all-time quarterly high of $7.0 billion in the second quarter. European investors reduced net purchases by 48% to $2.0 billion and Latin American and Caribbean investors, by 63% to $522 million. These reductions were mitigated by an 80% boost in Canadian net purchases to $402 million and a 43% increase in Asian net acquisitions to $1.9 billion. As was the case with gross activity, upscaled interest in U.S. equities by Japanese investors accounted for the increase from the Asian region.

TABLE I

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. EQUITIES
($ Millions)

	1986 Second Quarter		1986 Third Quarter	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$38,455	$3,819	$34,551	$1,983
Belgium-Luxembourg	2,375	275	2,350	271
France	2,908	358	2,109	316
Germany	2,779	(25)	2,432	(166)
Netherlands	1,854	455	1,484	138
Switzerland	10,275	807	8,487	(83)
United Kingdom	16,316	1,329	16,224	1,462
Canada	9,658	223	8,100	402
Latin America & Caribbean	10,717	1,405	9,726	522
Bermuda	3,092	357	3,023	229
Netherlands Antilles	2,990	217	2,788	39
Asia	11,480	1,305	16,224	1,869
Hong Kong	1,909	91	2,252	68
Japan	4,105	849	9,573	1,395
"Other Asia"*	4,800	220	3,554	317
Total All Countries	$72,117	$7,027	$70,282	$4,692

Source: U.S. Treasury

* Countries included are: Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, the United Arab Emirates.

European Investors

Through the first three quarters of 1986, European investors made net purchases of an impressive $10.6 billion of U.S. equities. From an exceptional $4.8 billion in the first quarter, net purchases were moderated in the second and third quarters, consecutively. The 48% drop from $3.8 billion in the second to $2.0 billion in the third quarter resulted from diminished interest in U.S. equities by investors located in Switzerland, the Netherlands and Germany.

TABLE II

NET PURCHASES OF U.S. EQUITIES - FIRST THREE QUARTERS 1986
($ Millions)

	1986 First Quarter	1986 Second Quarter	1986 Third Quarter	1986 Total 3 Quarters
Europe	$4,770	$3,819	$1,983	$10,614
Belgium-Luxembourg	135	275	271	683
France	(156)	358	316	510
Germany	598	(25)	(166)	423
Netherlands	396	455	138	991
Switzerland	1,406	807	(83)	2,153
United Kingdom	2,269	1,329	1,462	5,060
Canada	139	223	402	766
Latin America & Caribbean	344	1,405	522	2,284
Bermuda	4	357	229	589
Netherlands Antilles	175	217	39	447
Asia	860	1,305	1,869	4,170
Hong Kong	41	91	68	313
Japan	348	849	1,395	2,606
"Other Asia"	316	220	317	852
Total All Countries	$6,361	$7,027	$4,692	$18,281

Source: U.S. Treasury
Note: Quarterly data unrevised; Total incorporates revised data.

Swiss investors were quick to reverse their investment posture as the U.S. stock market rally lost its momentum in the third quarter. Swiss investors swung to net sellers of $83 million of U.S. equities from net purchasers of $807 million in the second quarter. The Swiss franc has been one of the highest scoring foreign currencies vis-a-vis the dollar, gaining over 8% in the third quarter. With both currency and stock market performance turning negative for U.S. investment, Swiss investors may have preferred their own domestic market. The June-July period witnessed tight liquidity conditions in Switzerland causing an upward spurt in both short- and long-term interest rates, with one-month funds touching a relatively high 6%.[1/]

1/ "Switzerland -- Banking, Finance, and Investment", Financial Times Survey, 12/10/86

German investors were the only major European investors to take a negative investment posture toward U.S. equities in the second quarter. This investment position was maintained in the third quarter, when net sales escalated to $166 million from $25 million in the second. Although the German stock market has made little progress in 1986, neither have German stocks borne the stigma of overpriced as have many other foreign stock markets. For those German investors buying U.S. equities based on the strength of the mark, attractive values in their home market, coupled with much speculation of interest rate reductions and subsequently a lower value for the mark, may have sent these investors seeking other investments.

Unlike their European brethren, U.K. investors increased net purchases of U.S. equities in the third quarter. The 10% boost put net purchases for the quarter at $1.5 and pushed total net purchases for the first three quarters of 1986 to $5.1 billion. This represents half of total European net acquisitions of U.S. equities. Concerns about lower oil prices, a rapid deterioration in Britain's current account and the ability of the British economy to continue to perform marked the third-quarter investment picture.[2/] Reflecting these factors, the U.K. stock market suffered a moderate setback and the pound, despite comparably high interest rates, took its first quarterly drop of the year against the dollar.

After stalling in the second quarter, the French stock market took a 7% stride upwards in the third quarter. Nevertheless, French investors maintained net purchases of U.S. equities at about the second-quarter level, over $300 million. Pent-up demand for portfolio diversification may be one factor prompting the continued attraction of French investors to U.S. equities. In May, the French government abolished the foreign exchange premium for purchases of foreign stocks.

Canadian Investors

Canadian investors almost doubled net purchases of U.S. equities to $402 million in the third quarter from $223 million in the second quarter, bringing net acquisition of U.S. stocks through the first three quarters to $766 million. Increasing interest in U.S. equities corresponded with decreasing Canadian interest rates. Although Canadian rates remain comparably high, yields in general were relatively unchanged or lower over the third quarter. Given its heavy weighting of natural resource stocks, the Canadian stock market has barely budged over the year despite good performance for those market sectors not commodity related. For those Canadian investors seeking greater equity diversification than offered by their domestic market, the U.S. market proved attractive.

2/ "Foreign Exchange Market Trends", Irving Trust, 10/2/86.

Latin American & Caribbean Investors

Net purchases of U.S. equities by Latin American and Caribbean investors dropped to $522 million in the third quarter from an unusually high $1.4 billion in the second quarter. For this quarter, as with previous quarters in 1986, activity stemming from countries other than those shown in Table I accounts for a large portion of flows. In the first three quarters of 1986, $2.3 billion of net purchases came from this region. About 45% of these purchases were made by investors located in Bermuda and the Netherlands Antilles. Other major players have been investors in the Bahamas, the British West Indies, Panama and Mexico, with net purchases ranging from $150 million to $332 million. Exchange rate considerations along with the stable and liquid U.S. markets promote investment flows from these countries.

Asian Investors

In the third quarter, Asian investors' net purchases of U.S. equities jumped 43% to $1.9 billion from $1.3 billion in the second quarter. The increasing interest of Japanese investors has been raising the level of net purchases from this region since the beginning of the year, supporting the contention that these traditionally fixed-income-oriented investors have broadened their investment strategy in 1986. Japanese statistics show net capital outflow into foreign shares at $4.3 billion through September of 1986, compared with only $1.7 billion for full-year 1985. Comparing these numbers with Treasury's, it would appear roughly 60% of Japan's foreign equity investment was in U.S. stocks. High dividends, a chance to own a piece of a world leader, and currency diversification are among the attractions for Japanese foreign investment.[3/] Not that Japanese investors have lost their appetite for foreign fixed income securities. Japanese statistics indicate that net purchases of these securities are $68.4 billion through the first nine months of 1986, about 8% more than total 1985 purchases.

Foreign Activity in U.S. Corporate Bonds

As European investors scaled back net purchases of U.S. corporate bonds, Japanese investors more than doubled their net purchases in the third quarter. However, interest by Japanese investors was not enough to offset the drop in activity by European investors. Foreign net purchases of corporate bonds fell 18% to $10.3 billion from $12.6 billion in the second quarter. In addition, gross activity plunged 36% to $25.1 billion, the lowest level for 1986 thus far.

3/ "Japanese Recycling Export Earnings Through Purchases of Foreign Stocks," Wall Street Journal, 10/21/86.

TABLE III

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. CORPORATE BONDS
($ Millions)

	1986 Second Quarter		1986 Third Quarter	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$31,921	$12,035	$17,804	$ 8,416
Belgium-Luxembourg	472	(158)	637	(12)
France	404	61	321	(13)
Germany	2,370	314	2,129	(278)
Switzerland	2,858	2,126	1,419	772
United Kingdom	25,341	9,639	12,776	7,828
Asia	5,229	6	4,957	1,251
Japan	2,308	613	3,080	1,486
"Other Asia"	2,390	(693)	1,112	(491)
Total All Countries	$39,213	$12,612	$25,103	$10,326

Source: U.S. Treasury

Net purchases of corporate bonds by European investors declined 30% to $8.4 billion from $12.0 billion in the second quarter. A 19% cutback in net purchases by U.K. investors to $7.8 billion and a sharp 64% reduction by Swiss investors precipitated most of the falloff. A steep widening of the nominal differential favoring U.K. corporate bonds from 132 basis points to 258 basis points caused U.K. investors to moderate net purchases of U.S. bonds. The interest rate differential between U.S. and Swiss instruments widened minimally in favor of U.S. bonds, but Swiss investors preferred other markets. The same interest rate analysis applies between U.S. and German issues. German investors, however, swung to net sellers of $278 million of U.S. corporate bonds.

Net purchases of U.S. corporate bonds by Asian investors jumped from an unusually low $6 million in the second quarter to $1.3 billion in the third quarter. Japanese investors made purchases of $1.5 billion, compared with $613 million in the second quarter. The increase in Japanese net purchases of corporate bonds coincides with stepped up Japanese aquisitions of both U.S. equities and Treasuries. Investors in the oil-exporting countries continued to make net sales, $491

million of corporate bonds compared with $693 million in the second quarter. Net activity by these countries in U.S.-dollar denominated assets in the past few years has reflected a drawing down of reserves. However, the level of these foreign reserves is reportedly unchanged. While these governments have made substantial drawings on their foreign assets, it is probably true that they have been able to make up the sums liquidated by capital gains in bond and equity markets.[4/]

Foreign Activity in U.S. Treasury Notes & Bonds

Substantial net sales of U.S. Treasuries by international and regional organizations overshadows net purchases made by other foreign investors in the third quarter. These organizations sold $3.4 billion of Treasuries, while European

TABLE IV

NET FOREIGN PURCHASES AND TOTAL FOREIGN HOLDINGS OF U.S. TREASURY NOTES AND BONDS
($ Millions)

	1986 Second Quarter		1986 Third Quarter	
	Net Purchases	Estimated Holdings	Net Purchases	Estimated Holdings
Europe	$5,448	$ 59,628	$4,222	$ 63,850
Switzerland	877	3,616	(294)	3,322
West Germany	964	24,013	2,910	26,923
United Kingdom	1,032	15,350	(142)	15,208
Asia	3,724	73,241	4,766	78,007
Japan	1,058	40,997	5,051	46,048
"Other Asia"*	1,030	21,908	(430)	21,478
Nonmonetary Int'l & Regional Org.	(780)	13,024	(3,431)	9,593
All Countries	$9,141	$157,874	$5,595	$163,469

Source: U.S. Treasury

* Treasury has discontinued publication of the estimated holdings of the oil-exporting countries. Figures based on last published figure plus summation of quarterly data.

4/ "Arab Banking", Financial Times Survey, 10/23/86

and Asian investors made combined net purchases of about $9.0 billion. Hence, total foreign net purchases of Treasuries fell by 39% to $5.6 billion in the third quarter from $9.1 billion. The pace of net foreign acquisition of Treasuries in 1986 is neck-and-neck with last year's, with net purchases at $22.4 billion through the first three quarters. Estimated foreign holdings of Treasuries are $163.5 billion as of the end of September.

News of the Japanese departure from the U.S. Treasury market was premature, albeit their interest in Treasuries is a far cry from 1985's $19 billion. Through the first three quarters of 1986, Japanese investors have acquired $7.0 billion of Treasuries, with $5.1 billion purchased in the third quarter alone. One factor prompting the third-quarter spurt in Japanese net purchases was the widening of the interest rate differential between U.S. and Japanese issues. While the yield on U.S. Treasuries increased 16 basis points from end-June to end-September, Japanese returns fell 25 basis points.5/

Similarly, a jump in yields on domestic issues may account for the swing to net sellers of $142 million of Treasuries by U.K. investors. The pound fell a sharp 6% against the dollar in the third quarter and, in response, U.K. government issue yields jumped 100 basis points in September. The slack in U.K. net activity was taken up by German investors. This increased interest, however, is not necessarily explained by interest rate differentials. There was much discussion of a German interest rate cut to stimulate the German economy and subsequently lower the mark. In lieu of decreases in interest rates, the Bundesbank probably made large purchases of Treasuries to temper the mark's rise against the dollar.

Also contributing to the $4.2 billion in European net purchases were acquisitions of $1.4 billion of Treasuries by investors located in the Netherlands (not shown in Table IV). These investors are not usually factors in the Treasury market. However, as has been the case in certain other quarters, foreign countries not generally major factors in the Treasury market have made sporadic large net purchases.

U.S. Activity in Foreign Stocks

Until the third quarter, U.S. investors were returning in like-kind the enthusiasm of foreign investors for U.S. stocks. At the half-year point, U.S. investors had made record net purchases of $4.2 billion of foreign stocks. However, six months does not a year make. U.S. investors swung to net sellers of $800 million of foreign stocks in the third quarter, bringing net purchases for the first nine months of 1986 to a

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5/ Based on data in World Financial Markets, Morgan Guaranty Trust Company.

still-significant $3.4 billion. Gross activity, nevertheless, continued at a record clip. U.S. investors' transactions in foreign stocks totaled $72.4 billion through the first three quarters of 1986, some 59% ahead of 1985's record $45.6 billion in gross activity.

Large-scale net sales of Japanese stocks weighted down U.S. activity in foreign stocks. The 1986 U.S. investment pattern in Japanese stocks seems to be one of all or nothing. After making net purchases of $1.1 billion in the first quarter, U.S. investors purchased only $198 million of Japanese stocks in the second quarter and swung to net sellers of $1.2 billion in the third quarter. After a hefty gain of over 20% in the first quarter, the Japanese stock market rise slowed in the second quarter. Although upward momentum resumed over the third quarter, the Japanese market was particularly turbulent in September. Some of the fuel for the third-quarter market climb stemmed from expectations of interest rate cuts. When a reduction in Japanese rates did not follow a decrease in U.S. rates, the Japanese stock market sold off sharply.

TABLE V

GROSS ACTIVITY IN AND NET PURCHASES OF FOREIGN STOCKS BY U.S. INVESTORS
($ Millions)

	1986 Second Quarter		1986 Third Quarter	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$12,702	$1,320	$13,320	$ 202
France	875	241	936	0
Germany	1,619	203	1,380	170
Netherlands	1,020	56	879	(75)
Switzerland	780	18	858	148
United Kingdom	7,430	746	8,507	55
Canada	3,326	330	1,995	(11)
Asia	7,591	123	9,962	(1,024)
Japan	6,660	198	8,911	(1,165)
Other	1,676	364	1,385	33
All Countries	$25,295	$2,137	$26,662	$ (800)

Source: U.S. Treasury

U.S. investors took a cautious approach to European stocks in the third quarter. Net purchases plunged to $202 million from $1.3 billion in the second quarter. Underlying the falloff was a sharp cutback in net purchases of U.K. stocks to $55 million in the third quarter from $746 million in the second. Both sterling and the U.K. stock market lost ground in the third quarter. U.S. investors focused their attention on Swiss stocks in the third quarter, upping net purchases to $148 million from $18 million in the second quarter. Though the Swiss stock market stagnated in the third quarter, Swiss economic fundamentals are favorable and the franc is enjoying a strong position in currency markets. U.S. transactions in French stocks resulted in a wash, while net purchases of German stocks were reduced by 16% to $170 million.

U.S. investors appear to have been selective buyers of Canadian stocks in the first half of 1986, with net purchases of $866 million made. Despite several fundamental investment negatives, including a large balance of payments deficit and high unemployment, issues on the Canadian stock markets that are not directly driven by commodity prices are doing well.6/ However, in the third quarter, U.S. investors were on the sidelines, making net sales of $11 million. The Canadian economy enjoyed surprisingly strong growth in the first half of the year. However, strong growth was not forecasted to continue in the second half as lower commodity prices, higher income taxes and a tight fiscal policy are expected to restrict growth.

Carolyn Hildebrandt
Assistant Vice President

6/ "World Stock Market Review", Institutional Investor, 10/86.

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An Analysis of Foreign Participation in the U.S. Securities Markets
Produced by the SIA Research Department

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Foreign Activity In U.S. Securities

"Highlights"

1. For the foreign investor, a soaring stock market outweighed consideration of an under-the-weather dollar in 1986. Foreign net purchases of U.S. equities broke annual-and-quarterly records to reach $18.6 billion, more than 3-times 1981's record of $5.8 billion. While U.K. investors maintained their traditional role as the largest purchaser of U.S. equities, Japanese investors assumed the second spot, making net purchases of an unprecedented $3.3 billion in 1986.

2. Foreign gross activity in U.S. equities climbed to a new plateau in 1986. Foreign transactions totaled $277.3 billion, 74% more than 1985's record $159.0 billion. We estimate that foreign activity could have accounted for roughly 11%-12% of the value of public trading on the NYSE, compared with an average 9%-9.5% in 1984 and 1985.

3. Although increased by 9% in aggregate, foreign net purchases of U.S. corporate bonds waned over the year with the decline in yields. Foreign net purchases of U.S. corporate bonds totaled $43.5 billion in 1986, compared with $39.8 billion in 1985.

4. It's true! Japanese investors slashed net purchases of Treasuries in 1986, with net acquisitions totaling a paltry $3.8 billion compared with $17.9 billion in 1985. Foreign net purchases of $24.3 billion in 1986 stemmed mainly from Europe, reflecting central bank efforts to stabilize the plunging U.S. dollar.

5. In the first half of 1986, a record annual level of U.S. interest in foreign stocks seemed to be in the cards. However, in the second half of the year, when the runup of many foreign stock markets slowed and the dollar turned feisty, U.S. investors adopted a cautious position on foreign investment, particularly Japanese stocks. Net purchases of foreign stocks summed to $1.5 billion in 1986, compared with 1985's record of $3.9 billion.

Overview

The magnitude of foreign investment in U.S. securities in 1986 attests to the phenomena of internationalization of world financial markets. In sum, foreign net capital inflows, including the buildup of foreign claims on the U.S., equaled one-half of U.S. net capital formation.[1/] For the U.S. equities market, foreign activity in 1986 represented a "no-holds-barred" record breaker. Foreign net purchases of U.S. equities reached an unprecedented $18.6 billion, more than 3-times 1981's record $5.8 billion. Gross activity soared to a new plateau, $277.3 billion, an increase of 74% from 1985's peak of $159.0 billion.

In the first half of the year, foreign investors focused on the 22% climb of the U.S. stock market and gave nary a nod to the falling dollar. Hoping for market appreciation to offset dollar depreciation, foreign investors made net purchases of $13.4 billion of U.S. equities in the first half of 1986. Neither the stock market's rise nor the dollar's slide was as smooth in the second half of the year. The record highs achieved by the market were punctuated by a record plunge in September and the dollar turned feisty for a brief period. While foreign net purchases slowed to a still-exceptional $4.7 billion in the third quarter, caution was distinctly evidenced in fourth-quarter net purchases of a paltry $267 million.

The path of economic growth in the U.S. in 1986 was an uneven one. The year started with a surprising burst of strength that was followed by an anemic second quarter. Overall, real GNP advanced at a 2.5% annual rate, compared to a 2.7% rate in 1985. Interest rates, which eased during the year, were keyed to the domestic economy. In several steps, the Federal Reserve cut its discount rate to 5.50% by year-end 1986 from 7.50% at year-end 1985. The dollar was left to the device of coordinated intervention by central banks.

1/ *Economic Report of the President*, U.S. Government Printing Office, January 1987.

International developments captured an unusual amount of attention during the year, as policymakers worldwide became increasingly concerned with global imbalances. The huge trade deficit of the U.S. contrasted sharply with the trade surpluses of our major trading partners. The depreciated dollar has been slow to show any effect on the current account deficit. Much speculation over appropriate values in foreign exchange markets and the appropriate fiscal and monetary policies in the leading industrialized countries marked the year.

With interest rates declining worldwide, investors increasingly looked to equity investment, thus providing the impetus for a continuation of 1985's stock market rallies. Although the climb of markets worldwide generally became more moderate as the year progressed, gains on a yearly basis were significant. The rise of the U.S. stock market was outpaced by several foreign markets. For example, U.S. stocks rose an average of 14% compared with an increase of almost 20% for U.K. stocks, 50% for French stocks, and 58% for Japanese stocks.[2/] Nevertheless, the U.S. stock market drew foreign funds like a magnet in 1986.

On a literal basis, the dollar's path was not a happy one in 1986. The dollar's fall, which began in early 1985, continued in 1986, interrupted only briefly in the August-October period. From year-end 1985 to year-end 1986, the dollar gave up over 25% to the Swiss franc, German mark, and yen. The French franc appreciated about 18% vis-a-vis the dollar. The dollar held a firmer course against sterling and the Canadian dollar, with these currencies gaining 3% and 1%, respectively, over the year.

Clearly, currency considerations were not the primary concern of foreign investors. A roaring stock market appears to have offset the sliding dollar in the first half of the year. However, foreign investors were quick to turn cautious when the stock market pitched and the dollar stood its ground in the latter half of the year.

When the market started 1987 headed for record levels, foreign investors once again became whole-hearted participants. Based on preliminary and confidential SIA data, we estimate that foreign investors made net purchases of $1.8-$2.0 billion of U.S. equities in January. Although only scattered data is available for February, that month looks like it outpaced January and foreign net purchases could come close to $3.0 billion.

2/Based on index of Morgan Stanley Capital International Perspective-Geneva.

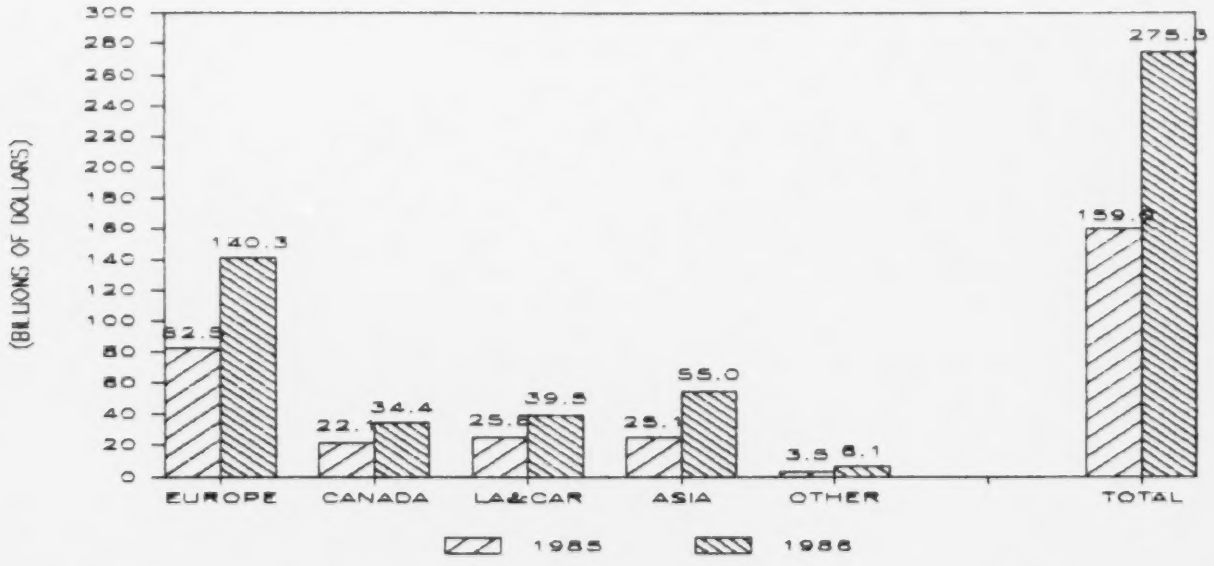
Foreign Activity in U.S. Equities

Gross Activity

Foreign gross activity in U.S. equities in 1986 reached a new plateau. Gross transactions hit a peak of $277.3 billion, 74% more than 1985's record $159.0 billion. Putting this in perspective, at the start of the 1980s, gross transactions totaled a now-meager $75.2 billion. Moreover, foreign transactions accounted for an estimated 11%-12% of the value of NYSE public trading in 1986, up from a steady 9%-9.5% in 1984 and 1985.

There was a virtual explosion of activity in U.S. equities from every major region. European activity increased 70% to $140.3 billion in 1986 from $82.5 billion in 1985. Canadian investors upped gross transactions by 55% to $34.4 billion and Latin America and Caribbean investors, by 53% to $39.5 billion. Not surprisingly, the highlight in gross activity stems from the Asian region, with transactions more than doubling to $55.0 billion from the 1985 level. The heightened interest of Japanese investors in U.S. equities accounted for this dramatic upswing. Japanese gross transactions in equities reached $26.9 billion in 1986, compared with $7.8 billion in 1985.

Gross Activity by Country
In U.S. Equities



Net Purchases

Paralleling the record-smashing course of gross activity was the record-smashing climb of net purchases to $18.6 billion. The 1981 high, $5.8 billion, pales in comparison. Interest in acquiring U.S. equities was wide-ranging, with every major region significantly stepping up net purchases from the 1985 level. European investors escalated net purchases to $9.4 billion, almost 5-times the 1985 level. Canadian investors more than doubled acquisitions to $795 million, while Latin America and Caribbean investors increased net purchases by 77% to $3.0 billion. As with regional gross activity, the most notable change in investment posture came from the Asian region, with net acquisitions jumping to $4.8 billion based on Japanese enthusiasm for U.S. equities.

Several gauges can be used to measure the magnitude of foreign involvement in the U.S. equity markets. For example, about $57.0 billion in equity offerings were brought to market in 1986. If foreign investors made net purchases of only these offerings, they would have accounted for some 33% of the new equity capital raised. To answer an oft asked question, foreign holdings of U.S. equities are estimated at $163.4 billion as of year-end 1986, or about 5.5% of total equities outstanding. This compares with holdings of $64.6 billion in 1981, about 4.3% of total equities outstanding at that year-end.

Percentage of Net Purchases
By Country of U.S. Equities

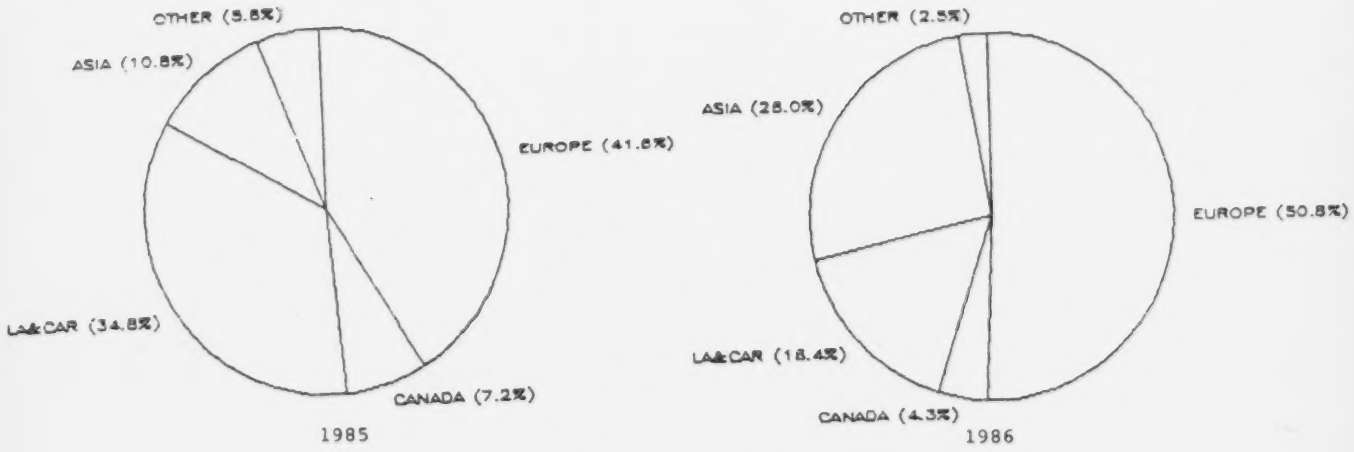


TABLE I

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. EQUITIES
($ Millions)

	1985		1986	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$82,503	$2,057	$140,275	$9,436
Belgium-Luxembourg	4,383	185	8,507	663
France	6,041	(438)	9,544	462
Germany	6,136	730	9,932	339
Netherlands	3,956	(123)	6,243	936
Switzerland	21,605	(75)	36,845	1,559
United Kingdom	37,622	1,665	63,311	4,702
Canada	22,141	356	34,401	795
Latin America & Caribbean	25,773	1,718	39,500	3,036
Bermuda	9,764	986	11,788	800
Netherlands Antilles	7,632	316	11,484	681
Asia	25,139	534	55,033	4,836
Hong Kong	3,523	(193)	8,295	403
Japan	7,805	281	26,943	3,289
"Other Asia"*	11,931	238	16,267	977
Total All Countries	$159,049	$4,941	$277,273	$18,566

Source: U.S. Treasury
Note: For 1985, all data are final. For 1986, net and total data include latest revisions and gross transactions are unrevised quarterly figures. This applies to all tables unless noted.
* Countries included are: Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, the United Arab Emirates.

European Investors

All major European countries were net acquirers of U.S. equities in 1986. Net purchases by investors in Europe soared to $9.4 billion in 1986 from $2.1 billion in 1985. U.K. investors remained as the traditional major acquirers of U.S. equities, with net purchases of $4.7 billion accounting for half of European investment.

U.K. investors stand firm as the largest purchasers of U.S. equities. Net purchases escalated to an unprecedented $4.7 billion in 1986 from $1.7 billion in 1985. The level of activity in 1986 is a shade below total foreign net purchases of $4.9 billion in 1985. The almost 20% increase in the U.K. stock market racked up in 1986 masks a divergent performance for the year. Most points were scored early in the year. Nevertheless, this optimism was short-lived as lower oil prices translated into downward pressure on the pound, higher interest rates, and troublesome adjustments for the U.K. economy.

Swiss interest in U.S. equities in the first half of 1986 coincided with a stalled domestic equity market. Swiss economic fundamentals are to be admired, with inflation nil for 1986 and continued stable growth in prospect. The Swiss market while putting in a mediocre year overall had a record new issues volume in 1986. With policies in-place which augur for increased attention to equity investments in 1987 by Swiss insurance companies and corporations, Swiss investors headed for home when their market picked up in the latter half of the year. Nevertheless, enthusiasm in the first six months of 1986 brought Swiss net purchases to $1.6 billion for the year.

French investors showed renewed interest in U.S. equities in 1986, making net purchases of $462 million in contrast to net sales of $438 million in 1985. French stocks enjoyed a roaring bull market in 1985 which carried full steam through the first quarter of 1986 before slowing up a bit during the remainder of the year. Governmental policies were established in past years to encourage investment and the French privatization program caught the attention of investors. In the space of a few months, the number of direct shareholders reportedly doubled, with the 3.8 million individuals who subscribed to the privatization of Paribas, the investment bank.3/ A penchant for equity investment and the elimination of the foreign exchange premium for purchases of foreign stocks prompted French investors to join in the enthusiasm for U.S. equity investment in 1986.

German investors dabbled only briefly in the U.S. equities market in 1986. After making net purchases of almost $600 million in the first quarter, these investors became net sellers of U.S. equities in the remainder of the year. Net purchases for 1986 came in at $339 million, or almost half of the 1985 level. While the U.S. stock market significantly outperformed the German market in 1986, the German mark was one of the strongest currencies vis-a-vis the dollar. In this case, investors were betting that capital appreciation would not offset currency depreciation.

3/ "French bourse flourishes after years of evolution," Financial Times, 3/11/87.

Canadian Investors

Although net purchases of U.S. equities by Canadian investors rose to over 2-times the 1985 level, activity by these investors in 1986 clearly lacked the enthusiasm of other foreign investors. Net purchases increased to $795 million in 1986 from $356 million in 1985. The Canadian stock market inched up a modest 6% in 1986, reflecting both a heavy weighting in natural resource stocks and certain troublesome economic fundamentals. The Canadian economy, while clipping along at about 3% growth, is plagued by comparably high inflation and unemployment and a large current account deficit. The Canadian authorities kept interest rates at high levels during much of the year to protect the beleaguered Canadian dollar. Canadian investors may have preferred the attractive returns on domestic fixed income instruments, in some cases almost 300 basis points above comparable U.S. instruments, to equity investment in 1986.

TABLE II

FOREIGN NET PURCHASES OF U.S. EQUITIES
($ Millions)

	1986 First Quarter	1986 Second Quarter	1986 Third Quarter	1986 Fourth Quarter
Europe	$4,770	$3,819	$1,983	$(1,193)
Belgium-Luxembourg	135	275	271	(21)
France	(156)	358	316	(49)
Germany	598	(25)	(166)	(86)
Netherlands	396	455	138	(55)
Switzerland	1,406	807	(83)	(594)
United Kingdom	2,269	1,329	1,462	(370)
Canada	139	223	402	28
Latin America & Caribbean	344	1,405	522	750
Bermuda	4	357	229	210
Netherlands Antilles	175	217	39	234
Asia	860	1,305	1,869	666
Hong Kong	41	91	68	90
Japan	348	849	1,395	683
"Other Asia"	316	220	317	124
Total All Countries	$6,361	$7,027	$4,692	$267

Source: U.S. Treasury
Note: Quarterly data unrevised; total incorporates revised data.

Latin America & Caribbean Investors

Net capital flows into U.S. equities from these countries rose by 77% in 1986 to $3.0 billion from $1.7 billion in 1985. Activity by the two countries shown in Table II account for only about 50% of the total net purchases made, as other countries usually not interested in U.S. equities were active in 1986. For example, net purchases from the Bahamas and British West Indies were over $300 million, while net inflows from Mexico and Panama exceeded $200 million. The breadth and stability of U.S. markets is a primary consideration for investors from this region.

Asian Investors

Asian net purchases of U.S. equities skyrocketed to $4.8 billion in 1986 from $534 million in 1985. While all major countries in the region increased net purchases, it was the new-found enthusiasm of Japanese investors for U.S. equities that drove regional activity to an all-time high. These investors escalated net purchases to $3.3 billion from $281 million in 1985, thus becoming the second largest acquirer of U.S. equities in 1986. Of the $7.0 billion Japanese investors reportedly purchased of foreign equities in 1986, just under 50% found its way to the U.S. market. In part, the shift in the investment preference of Japanese investors was spurred by the declining yield spread between U.S. and Japanese government bonds. These spreads narrowed from almost 400 basis points at the beginning of the year to just under 300 basis points by the end of 1986. Hence, Japanese investors turned to the high return potential in the U.S. equity market.

Foreign Activity in U.S. Corporate Bonds

In a year characterized by speculation over which country would succumb next to pressures to cut its discount rate, foreign investors increased their net purchases of U.S. corporate bonds including Euro issues, by 9% to $43.5 billion from $39.8 billion. Foreign interest in U.S. corporate bonds waned with the downward trend of yields. With only occassional and moderate spurts, corporate bond returns declined as 1986 progressed, starting the year at an average of 10.38% and closing it at 8.88% in December.[4/] Foreign investors were net purchasers of over $24.0 billion of U.S. corporate bonds in the first half of 1986, as compared to only $9.2 billion in the last quarter of the year.

4/Yield analysis in this report based on data in World Financial Market, Morgan Guaranty Trust Co.

TABLE III

GROSS TRANSACTIONS IN AND NET PURCHASES OF
U.S. CORPORATE BONDS
($ Millions)

	1985		1986	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$63,595	$37,237	$95,621	$37,699
Belgium-Luxembourg	1,001	213	1,996	(19)
France	1,573	218	1,810	255
Germany	7,738	2,110	10,635	(321)
Switzerland	6,445	3,903	9,463	4,459
United Kingdom	45,671	30,498	71,476	32,807
Asia	12,241	2,053	21,582	4,447
Japan	6,527	3,001	12,794	5,083
"Other Asia"	4,075	(1,459)	6,005	(1,601)
Total All Countries	$83,462	$39,792	$128,224	$43,467

Source: U.S. Treasury

European net purchases of $37.7 billion of U.S. corporate bonds in 1986 remained virtually on par with the 1985 level. Only German investors significantly changed their investment posture, swinging to net sellers of $321 million from net purchasers of $2.1 billion in 1985. With German policymakers consistently resisting interest rate cuts, yields on German corporate bonds drifted down only minimally over the year. Hence, the spread differential between U.S. and German issues narrowed by almost 120 basis points.

The turnaround by German investors was taken up by moderately upscaled interest in U.S. corporate bonds by Swiss and U.K. investors, who made net purchases of $4.5 billion and $32.8 billion, respectively. While the yield spread between U.S. and U.K. rates actually widened substantially in favor of U.K. issues over the year, U.K. investors continued to make large net purchases of U.S. corporate bonds. Economic fundamentals shed little light on the high level of U.K. interest. There is the possibility that U.K. money managers acting as intermediaries for investors in other countries accounted for sustaining the trend. For example, Japanese investors showed an increased preference for U.S. corporate bonds directly.

With diminishing returns on U.S. Treasuries, Japanese investors turned their attention to the higher, albeit declining, returns available on U.S. corporate bonds. These investors boosted net purchases by 69% to $5.1 billion in 1986 from $3.0 billion in 1985. Consistent with the pattern of previous years, the oil-exporting countries made net divestitures of U.S. corporate bonds, $1.6 billion in 1986 compared with $1.5 billion in 1985.

Foreign Activity in U.S. Treasury Notes & Bonds

Foreign net acquisitions of U.S. Treasury notes and bonds slowed some 17% in 1986 from 1985's pace. Net purchases totaled $24.3 billion in 1986 compared with $29.2 billion in 1985. Of note, central banks took the lion's share of Treasuries in 1986. In contrast, activity in recent years has been dominated by private foreigners and institutions, which acquired $20.6 billion of Treasuries in 1985 compared with $11.1 billion in 1986. The narrowing yield spread between U.S. Treasuries and similar foreign government instruments coupled with the falling dollar prompted these investors to turn to equity markets for U.S. dollar investment. Hence, the intervention of foreign central banks to stabilize the dollar was the driving force in foreign activity in Treasuries in 1986.

Much ado was made in 1985 over the substantial purchases of Treasuries, $17.9 billion, by Japanese investors and the subsequent specter of their withdrawal from the Treasury market in 1986. While these investors slashed net purchases of Treasuries in 1986 to $3.8 billion, Japanese funds have been funneled at record levels into other U.S. dollar-denominated investments, both equities and corporate bonds. Other past major players in the Treasury market, the oil-exporting countries, continued to be net sellers. This position has been held since about early 1983, when lower oil prices spelled dwindling surpluses for these countries. The oil-exporting countries withdrew $1.5 billion of funds from Treasuries in 1986, on par with 1985 activity. Unusually large net purchases of $1.3 billion stemming from Korea (not shown in Table IV) boosted net acquisition from the Asian region to $5.2 billion, a far cry from the $19.9 billion acquired in 1985.

Net acquisition of Treasuries stemming from Europe jumped to $17.3 billion in 1986 from $4.3 billion in 1985. These net purchases reflected mainly the efforts of central banks to steady the decline of the dollar. Most notably, net purchases stemming from Germany totaled $7.8 billion in 1986 compared with $1.9 billion in 1985. After a sluggish first quarter, the Germany economy set on a path which looked headed toward strong growth in 1986. With economic fundamentals promising and monetary growth running above targeted ranges, the German central bank resisted pressures to stimulate its economy during much of the year. Nevertheless, the German central bank appears

to have provided considerable support to buoy the sinking dollar and dampen the rise of the mark. Net purchases of $4.7 billion of Treasuries stemmed from the U.K. which exhibited both strength and weakness vis-a-vis the dollar during the year. Also contributing to the heightened level of European net acquisitions were purchases of $1.3 billion of Treasuries from the Netherlands (not shown in Table IV).

TABLE IV

NET FOREIGN PURCHASES
OF U.S. TREASURY NOTES AND BONDS
($ Millions)

	1985 Net Purchases	1986 Net Purchases
Europe	$4,303	$17,327
Switzerland	773	415
West Germany	1,917	7,805
United Kingdom	(1,810)	4,725
Asia	19,919	5,171
Japan	17,909	3,800
"Other Asia"	(1,547)	(1,494)
Nonmonetary Int'l & Regional Organizations	440	(1,147)
Total All Countries	$29,208	$24,308

Source: U.S. Treasury
Note: Without an official benchmark by which to gauge the accuracy of estimated holdings, we have decided to discontinue publishing total foreign holdings of U.S. Treasuries.

U.S. Investor Activity in Foreign Stocks

In the first half of 1986, a record annual level of U.S. investor interest in foreign stocks for the year appeared to be a shoo-in. Net purchases in the January-June period totaled $4.2 billion. However, in the second half of the year, when the runup of many foreign stock markets began to lose steam and the dollar had brief shows of muscle, U.S. investors adopted a cautious stance toward foreign investment, particularly Japanese stocks. Hence, U.S. investor net purchases of foreign stocks summed to $1.5 billion in 1986, compared with 1985's record of $3.9 billion. Nevertheless, the level of gross activity rose to a dramatic high, $101.3 billion, more than 2-times 1985's peak of $45.6 billion.

After making large net purchases of over $1 billion in the first quarter, U.S. investors decided not to ride out the year in the characteristically wild and wooly Japanese stock market. U.S. investors sold $1.6 billion of Japanese stocks in 1986 compared with net purchases of $96 million in 1985. While the market chalked up a 58% gain overall, U.S. investors were net sellers of $2.9 billion in the second half of the year. Among the factors percipitating the selloff were the economic ramifications of the yen/dollar relationship and estimates of sharp declines in corporate profits, some as high as 30%-40%. U.S. investors were not the only ones exiting the Japanese stock market in 1986, as foreign investors reportedly sold over $19 billion of Japanese equities during the year in contrast to about $3 billion in 1985.

U.S. net purchases of European stocks dropped 18% to $1.6 billion in 1986 from $1.9 billion in 1985. However, the aggregate number belies the extent of U.S. interest, as net purchases of stocks in most major countries were increased. Yearly activity was dampened by net sales of $454 million of stocks of companies located in the Netherlands. The ripple effect of uncertain oil prices played havoc with the natural gas rich Dutch economy and strains on the guilder-mark relationship made U.S. investors wary of Dutch investments. In addition, net purchases of French stocks were reduced a minimal 4% to $297 million in 1986.

U.S. investors boosted net purchases of U.K. stocks by 67% to $1.3 billion in 1986 from $764 million in 1985. However, almost 87% of U.S. net purchases occurred in the first half of the year, coinciding with the sharp climb of the U.K. market. In the second half of the year, investor attention may have swung to the host of problems the U.K. economy had to deal with in 1986: high interest rates, pressure on the pound, and a deteriorating trade balance. U.S. net purchases of German stocks were increased by 30% to $452 million and of Swiss stocks by 10% to $302 million.

U.S. investors maintained a high level of interest in Canadian stocks in 1986, with net acquisitions at virtually the same pace as 1985, around $1.1 billion. With the Canadian dollar one of the few currencies to feel pressure vis-a-vis the U.S. dollar in 1986 and a sluggish stock market, we believe U.S. investors were selective buyers, focusing mainly on gold-related stocks as well as those export companies which would benefit from the weakness of the Canadian dollar.

TABLE V

GROSS TRANSACTIONS IN AND NET PURCHASES OF FOREIGN STOCKS BY U.S. INVESTORS
($ Millions)

	1985		1986	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$21,501	$1,909	$52,744	$1,566
France	1,225	311	3,835	297
Germany	1,909	347	6,072	452
Netherlands	1,914	(22)	3,752	(454)
Switzerland	1,633	275	3,144	302
United Kingdom	13,310	764	32,350	1,274
Canada	6,838	1,232	9,802	1,082
Asia	14,052	660	31,971	(1,147)
Japan	11,584	96	27,565	(1,625)
Other	3,224	92	6,116	250
Total All Countries	$45,615	$3,893	$101,252	$1,492

Source: U.S. Treasury

TABLE VI

NET PURCHASES OF FOREIGN STOCKS BY U.S. INVESTORS
($ Millions)

	1986 First Quarter	1986 Second Quarter	1986 Third Quarter	1986 Fourth Quarter
Europe	$ 556	$1,320	$ 202	$(512)
France	199	241	0	(143)
Germany	125	203	170	(46)
Netherlands	(281)	56	(75)	(154)
Switzerland	43	18	148	93
United Kingdom	360	746	55	113
Canada	536	330	(11)	227
Asia	1,302	123	(1,024)	(1,548)
Japan	1,097	198	(1,165)	(1,755)
Other	(306)	364	33	159
Total All Countries	$2,088	$2,137	$(800)	$(1,674)

Source: U.S. Treasury
Note: Quarterly data unrevised.

Carolyn Hildebrandt
Assistant Vice President

SIA

Foreign Activity

An Analysis of Foreign Participation in the U.S. Securities Markets
Produced by the SIA Research Department

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Foreign Activity in U.S. Securities

"Highlights"

1. Foreign net purchases of U.S. equities in 1986 came to a record-shattering $18.7 billion, albeit the level of acquisition plunged in the last quarter of the year. Nevertheless, when the U.S. stock market started 1987 headed for a new record, foreign investors once again acquired a record quarterly amount of U.S. equities. Foreign net purchases of U.S. equities in the first quarter of 1987 reached an all-time high of $9.8 billion, a level equal to over half of the 1986 record. Japanese interest accounted for $3.5 billion, which exceeded their full-year 1986 net activity.

2. Foreign gross activity in U.S. equities is off to a running start on last year's record $277.6 billion. By the end of the first quarter, heightened gross activity of $113.0 billion already measured up to 41% of total 1986 activity.

3. Foreign interest in U.S. corporate bonds waned with the downtrend of yields in 1986. On a quarterly basis, yields declined in the first quarter and so too did foreign net purchases of corporate bonds. Net purchases dropped 18% to $7.7 billion from $9.4 billion in the last quarter of 1986.

4. Reflecting central banks' intervention to steady the dollar, particularly in March, net foreign purchases of Treasuries in the first quarter were $13.9 billion. Activity by Japanese private institutions and investors appears to have offset central bank efforts, as net sales of $688 million of Treasuries were recorded for the first quarter.

5. Like the U.S. market, many foreign stock markets began 1987 with strength. After making net sales of $1.7 billion of foreign stocks in the fourth quarter of 1986, U.S. investors tested foreign waters again, adding $1.8 billion of foreign stocks to their portfolios during the first quarter of 1987.

Overview

A booming U.S. stock market, coupled with a declining dollar which made U.S. stocks a "bargain", captured the attention of investors worldwide in 1986. Foreign net purchases of U.S. equities, $18.7 billion, were more than three times the previous record. Much of this exceptional attraction to U.S. stocks was recorded in the first half of 1986, when the stock market was at its strongest and the dollar was in an uninterrupted slide. With the directions of both these investment factors less certain in the second half of the year, the pace of foreign net accumulation of U.S. equities slowed. Nevertheless, when the stock market started 1987 headed for new records, foreign investors once again exhibited record interest in U.S. equities. In the first three months of 1987, foreign net purchases of U.S. equities reached an all-time quarterly high of $9.8 billion, an amount equal to over 50% of 1986's unprecedented level.

Although the U.S. stock market lost steam as the quarter progressed, its 20% gain placed it among the world's top performing markets in the first quarter. In local currency terms, other major markets came in around the 20% mark in the same period, including Japan and, surprisingly, the U.K. Outpacing these gains, however, was the Canadian market's leap of 23%. The robust increases scored by many major markets in the first quarter brought worldwide investors back into equity markets with vigor. Although not a record, U.S. investors added $1.3 billion of foreign stocks to their portfolios in the first quarter.

International issues remained in the media forefront in the first quarter. The dollar was dragged down in the early part of the year by prospects of sluggish U.S. economic growth, which did not in fact materialize for the first quarter, and a further lowering of U.S. interest rates. However, the dollar entered a relatively stable period when interest rates firmed and market participants took to heart the Paris accord's intent-to-stabilize message. Nevertheless, all major currencies continued to appreciate against the dollar over the period. The pound and the yen increased by 8% vis-a-vis the dollar. Gains scored by the Canadian dollar, French franc, Swiss franc and German mark ranged from 6% to 7%. Clearly,

foreign investors adopted the same investment strategy that applied in much of 1986 -- the hopes that U.S. stock market appreciation would offset currency depreciation.

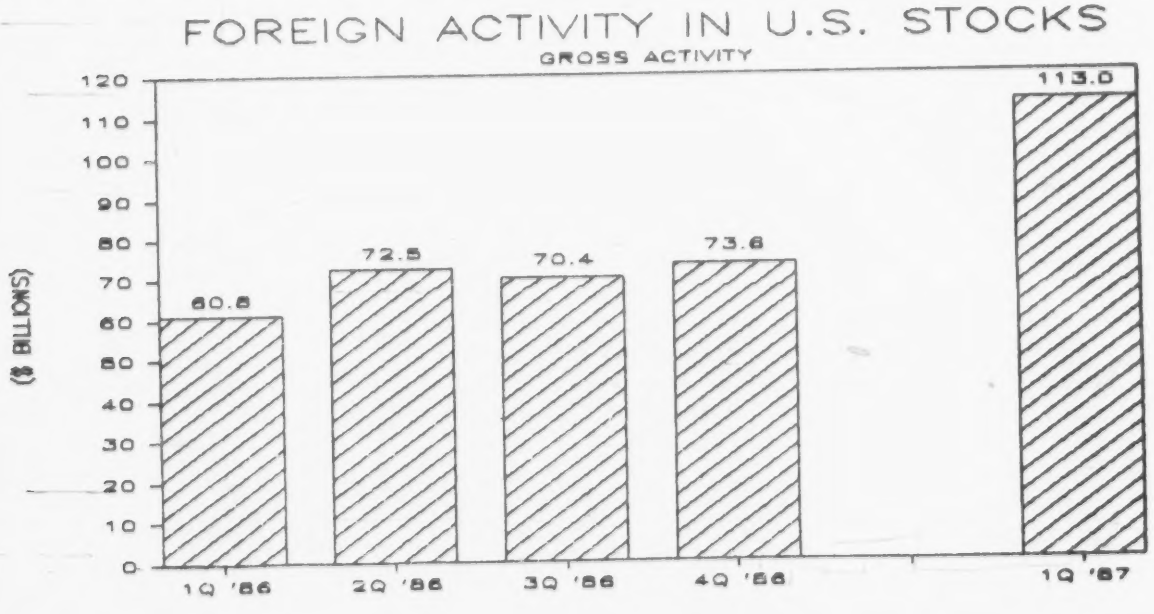
Preliminary and confidential SIA data indicate that foreign investors remained major participants in the U.S. equities market in April, with net purchases estimated at about $3.0 billion.

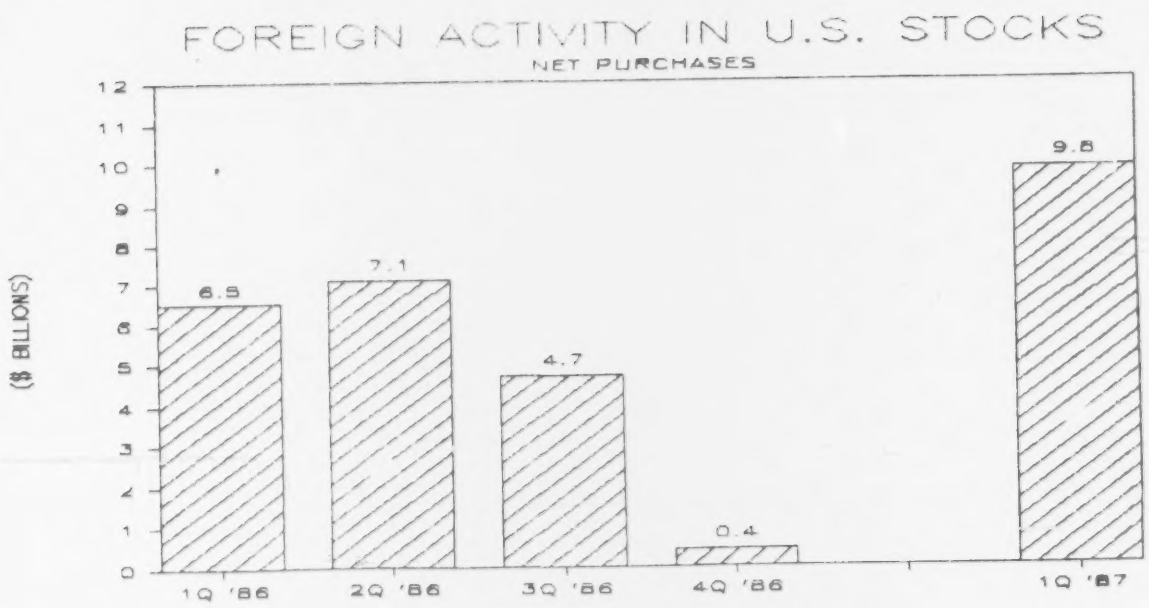
Foreign Activity in U.S. Equities

Gross Activity

All major regions dramatically stepped up activity in U.S. equities in 1986, sending gross transactions to a record $277.6 billion or 75% more than the 1985 high of $159.0 billion. The heightened interest in U.S. equities continued in the first quarter of 1987, with gross transactions jumping 54% to $113.0 billion from the fourth-quarter 1986 high of $73.6 billion. Hence, at the end of the first quarter, foreign transactions in U.S. equities already measured up to 41% of total 1986 activity.

Every major region increased gross transactions in the first quarter of 1987 from the fourth-quarter level. The most significant escalations came from European investors, 66%, and Asian investors, 62%. Within these two major regions, Swiss, U.K. and Japanese investors accounted for the largest increases in transactions. In addition, gross transactions by Canadian investors were up by 40% and by Latin American and Caribbean investors, by 6%.





Net Purchases

Foreign acquisition of U.S. equities reached a new record in the first quarter of 1987. Based on exceptional net activity of $5.1 billion in March, foreign investors acquired $9.8 billion of U.S. equities in the first three months of 1987. Enthusiasm from every major region for U.S. equities was revived from the fourth-quarter level, but only the Asian region set a new record for quarterly net purchases. The avid interest of Japanese investors propelled net investment by the Asian region to $3.6 billion. Net purchases by European investors, $4.7 billion, missed surpassing the first-quarter 1986 high of $4.8 billion by a hair. In addition, both Canadian and Latin American and Caribbean investors escalated net purchases to $327 million and $1.0 billion, respectively.

European Investors

Pushed by large net purchases of $4.8 billion by U.K. investors, European investment in U.S. equities totaled $9.6 billion in 1986 or over half of total 1986 foreign net purchases. While most major European investors returned with confidence to the U.S. market in the first quarter, it was mainly the activity of U.K. and French investors which brought European net purchases to $4.7 billion, a shade away from the quarterly high.

In comparison to their European brethren, French investors were modest investors in U.S. equities in 1986, with net purchases totaling $459 million. French investors seemed content to focus on a rising domestic market and the government's privatization program, which has more than tripled

TABLE I

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. EQUITIES
($ Millions)

	Fourth Quarter 1986		First Quarter 1987	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$33,775	$(1,053)	$55,994	$4,682
Belgium-Luxembourg	2,233	(21)	2,625	180
France	2,491	(49)	4,541	1,242
Germany	2,010	(84)	3,785	97
Netherlands	1,447	(55)	2,027	213
Switzerland	8,465	(593)	15,306	379
United Kingdom	15,910	(232)	25,406	2,419
Canada	9,174	28	12,859	327
Latin America & Caribbean	11,425	741	12,144	1,011
Bermuda	3,495	202	2,943	(15)
Netherlands Antilles	3,394	234	4,516	491
Asia	18,075	669	29,272	3,616
Hong Kong	2,703	90	2,814	98
Japan	9,863	688	17,728	3,495
"Other Asia"*	4,148	123	7,262	(270)
Total All Countries	**$73,606**	**$401**	**$113,044**	**$9,833**

Source: U.S. Treasury
* Countries included are: Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, the United Arab Emirates.

the number of individual shareholders since it began in 1986 to 5.5 million. In the first quarter of 1987, French net purchases of U.S. equities rose to an unusually high $1.2 billion, ranking French investors as the second largest European buyers of U.S. equities. The rise of the U.S. market outpaced the French market in the first quarter but not by an exorbitant margin. In addition, the gloominess of short-term forecasts has prompted excessive pessimism about the long-term competitiveness of French industry.[1/] Neverthless, despite several negatives for French domestic investment, we find the

1/"France", Financial Times Survey, 6/15/87.

recorded level of investment in U.S. equities unusually high.

Prospects for the U.K. economy turned quite optimistic in the first quarter and, with the help of firming oil prices, the pound enjoyed an exceptional advance on the dollar. Reflecting these and other factors, the U.K. stock market rose 20% over the quarter. The U.K. investment picture is also getting a boost from increased attention by Japanese investors. With investments in the U.S. hurt by a weaker dollar, many Japanese are diversifying into British stocks, lured by a bullish economic outlook and a stable currency.[2/] U.K. enthusiasm for equity investment extended to U.S. stocks in the first quarter. U.K. investors swung from net sellers of $232 million of U.S. stocks in the fourth quarter to net purchasers of a large $2.4 billion in the first quarter.

Other major European investors returned to the U.S. market in the first quarter, albeit the level of investment is modest in comparison to quarterly levels in the first half of 1986. With their domestic markets losing ground over the first quarter, Swiss and German investors made net purchases of $379 million and $97 million, respectively, of U.S. equities. In addition, as the U.S. market's rise outpaced their home markets, Dutch investors purchased $213 million of U.S. equities and Belgium investors, $180 million.

Canadian Investors

By the fourth quarter of 1986 what had been comparably moderate Canadian interest in U.S. equities eroded to minimal. Net purchases by these investors were just short of the $800 million mark in the first three quarters of 1986 and crossed that mark for the year with fourth-quarter net purchases of $28 million. Canadian investors, however, were whole-hearted participants in the first-quarter 1987 U.S. market rally, with net purchases of $327 million. Equity investment overall captured the attention of Canadian investors, as the Canadian market jumped some 23% in the first quarter after a modest gain of around 5% in 1986. Aside from the heating up of investor interest in gold-related stocks, Canadian markets were the recipient of considerable attention from Japanese investors. Despite nagging economic problems in Canada, the Canadian dollar has been riding high on the back of Japanese capital inflows and an attractive interest rate differential compared to the U.S.[3/] Indeed, the Canadian dollar gained almost 6% against the U.S. dollar in the first quarter.

2/"Japanese Start to Buy British Blue Chips," Wall Street Journal, 6/15/87.

3/"Foreign Exchange Market Trends," Irving Trust Company, 4/16/87.

Latin American & Caribbean Investors

As has been the case in 1986, the rising U.S. market and currency considerations prompted increased investment flows from the Latin American and Caribbean region. While transactions stemming from the Netherlands Antilles resulted in relatively large net purchases of $491 million, activity by several other countries pushed up net acquisition by the region. For example, net purchases of almost $100 million each of U.S. equities were made by investors located in the Bahamas, Mexico and Panama. Net purchases from this region total a significant $1.0 billion in the first quarter, almost one-third of 1986's level of $3.0 billion.

Asian Investors

As was the case last year, the momentum behind the heightened activity from the Asian region in the first quarter of 1987 came from Japanese investors. In 1986, net purchases from this region were $4.8 billion, 69% of which stemmed from Japan. This pattern continued in the first quarter, with net purchases leaping to $3.6 billion, almost entirely the result of Japanese acquisitions.

The Japanese penchant for U.S. equities was a very noted trend in 1986, as yield/dollar considerations made Treasuries less attractive to these investors. Nevertheless, Japanese net purchases of $3.5 billion of equities in the first quarter surpass total 1986 net purchases of $3.4 billion by 6%. There are several factors that may explain the dramatic escalation of Japanese U.S. equity investment in the first quarter. The majority of Japanese net investment occurred in March, the end of the Japanese fiscal year which may have prompted more than the usual amount of activity. Japanese capital outflows to foreign equity markets jumped 90% in March from the February level, while outflows to foreign bond markets were slashed by 65%. Inflationary concerns, very much in evidence by the end of the quarter, would only add momentum to the shifting of Japanese portfolios to equity investment from fixed income investment.

Foreign Activity in U.S. Corporate Bonds

Foreign interest in U.S. corporate bonds, including Euro issues, waned in 1986 with the downward trend of yields. Foreign net purchases totaled $43.7 billion for the year, with fourth-quarter net purchases of $9.2 billion representing the low point in 1986. Yields on U.S. corporate bonds dropped 38 basis points in January to 8.50% from 8.88% at the end of December, but inched up over the next two months to close the quarter at 8.65%.[4/] Foreign interest in U.S. corporate bonds

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4/Yield data from World Financial Markets, Morgan Guaranty Trust Company.

was relatively modest in January-February, averaging $2.7 billion. With the 15 basis point uptick in yields in March, foreign investors purchased $4.3 billion. Largely on the March surge, foreign net purchases of U.S. corporate bonds came to $7.7 billion in the first quarter of 1987, a drop of 18% from the fourth-quarter level.

European net purchases of U.S. corporate bonds fell 24% in the first quarter to $6.2 billion from $8.1 billion in the fourth quarter. Much of the cutback in net activity resulted from transactions by U.K. investors. These investors, who purchased $32.8 billion of U.S. bonds in 1986, reduced net purchases by 27% to $5.3 billion from $7.3 billion in the last quarter of 1986. Although the yield spread between U.S. and U.K. issues narrowed over the quarter, U.K. corporate bonds maintained a still-healthy lead. Nevertheless, the U.K. pullback may reflect a number of other factors: The pounds's advance on the dollar, a booming domestic equity market and a favorable economic picture for domestic investment in general. On the other hand, Swiss net purchases of U.S. bonds more than doubled to $724 million in the first quarter, and German investors swung to net purchasers of $117 million from net sellers of $123 million in the last quarter of 1986.

Somewhat surprisingly, net purchases stemming from the Asian region increased 19% to $1.1 billion from $913 million. Despite evidence of Japanese portfolio shifting to equity investment as well as out of U.S. fixed income markets,

TABLE II

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. CORPORATE BONDS
($ Millions)

	Fourth Quarter 1986		First Quarter 1987	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$21,701	$8,084	$18,300	$6,176
Belgium-Luxembourg	629	163	501	(174)
France	587	205	613	98
Germany	1,727	(123)	1,381	117
Switzerland	3,080	332	1,788	724
United Kingdom	15,030	7,306	13,096	5,300
Asia	6,121	913	4,974	1,090
Japan	3,862	1,086	3,775	1,059
"Other Asia"	1,309	(551)	523	(43)
Total All Countries	$30,607	$9,422	$25,726	$7,698

Source: U.S. Treasury

aquisition of U.S. corporate bonds was on par with t[illegible] fourth-quarter level, $1.1 billion. Net selling by the oil-exporting countries moderated sharply to $43 million from $551 million in the fourth quarter of 1986.

Foreign Activity in U.S. Treasury Notes & Bonds

Downtrending yields and the falling dollar sent private foreigners and institutions to the equity market for U.S.-dollar investment in 1986. Hence, foreign net purchases of $24.2 billion of U.S. Treasuries reflect intervention activity of central banks to prop up the declining dollar. This pattern continued through the first quarter of 1987, as central banks and international non-monetary organizations purchased $15.3 billion of Treasuries, while private foreigners and institutions made net divestitures of $1.4 billion. Foreign net acquisition for the quarter totaled $13.9 billion, compared with $1.8 billion in the fourth quarter of 1986. Estimated foreign holdings of Treasuries was $272.1 billion at the end of March.

The dollar enjoyed a bit of tranquillity in February, as markets calmed waiting news of the Paris meeting and U.S. interest rates firmed. The breather was only temporary for the dollar, as in March the foreign exchange markets tested the central banks' resolve to stabilize the dollar. Attempts to steady the dollar resulted in official institutions' net purchases of a dramatic $5.0 billion of Treasuries in March.

TABLE III

NET FOREIGN PURCHASES OF
U.S. TREASURY NOTES AND BONDS
($ Millions)

	Full Year 1986 Net Purchases	Fourth Quarter 1986 Net Purchases	First Quarter 1987 Net Purchases
Europe	$16,854	$3,320	$8,115
Switzerland	310	(478)	1,721
West Germany	7,531	2,710	3,353
United Kingdom	4,648	842	1,530
Asia	5,466	(2,248)	(2,017)
Japan	4,048	(2,349)	(688)
"Other Asia"	(1,473)	(1,412)	(1,456)
Nonmonetray In't & Regional Organizations	(1,103)	(165)	8,069
Total All Countries	$24,173	$1,764	$13,856

Source: U.S. Treasury

While the dollar was weakest against the yen during the first quarter, Japanese net selling of $688 million was recorded, with an estimated $2.4 billion sold in March. We believe the activity of private foreign institutions and individuals switching out of Treasuries and into U.S. equities and other investments offset central bank activity. In April, it was estimated that another 10% drop in the yen/dollar exchange rate would wipe out two-year's worth of the 5% yield differential separating long-term U.S. Treasury bonds from Japanese bonds.5/

European activity in the U.S. Treasury market resulted in net purchases of $8.1 million. Over 40% or $3.4 billion of these net purchases stemmed from Germany, reflecting central bank efforts to support the dollar as well as dampen the strong mark. Much of the German central bank's resistance to pressure to cut interest rates in 1986 stemmed from a reluctance to tamper with the favorable economic fundamentals which were in place. However, the strong DM caught up with the German economy in the first quarter. Exports dropped off, domestic demand was not strong enough to offset the erosion, and economic growth forecasts were sharply reduced.

U.S. Investor Activity in Foreign Stocks

At the beginning of 1986, U.S. investor interest in foreign stocks looked to be headed toward a record level. However, diminished interest in foreign stocks overall coupled with large net sales of Japanese stocks in the second half of the year brought net U.S. investment in foreign stocks to $1.3 billion for 1986. Although the U.S. dollar showed considerable volatility as it continued to slide in the first quarter of 1987, stock markets worldwide began the year with strength. In addition, inflationary concerns piqued investor interest in precious metals. The increased attention of U.S. investors to U.K. and Canadian investment could reflect this interest. For the first quarter of 1987, U.S. investors made net purchases of $1.3 billion of foreign stocks in contrast to net sales of $1.7 billion in the last quarter of 1986.

Of particular note is the level of gross activity in the first quarter. In 1986, U.S. gross transactions in foreign stocks leaped to a record of $102.0 billion. First-quarter 1987 gross transactions of $40.2 billion gives this year a running start on surpassing 1986's record. While a heightened level of gross transactions does not necessarily translate into record net investment, it does attest to the increased participation of U.S. investors in foreign markets.

5/"Foreign Exchange Market Trends", Irving Trust Company, 4/30/87

TABLE IV

NET PURCHASES OF
FOREIGN STOCKS BY U.S. INVESTORS
($ Millions)

	Fourth Quarter 1986		First Quarter 1987	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$15,396	$(512)	$20,302	$1,104
France	1,267	(143)	1,396	40
Germany	1,584	(46)	2,070	(194)
Netherlands	964	(154)	1,055	193
Switzerland	829	93	1,307	(33)
United Kingdom	9,605	113	12,989	1,277
Canada	2,037	227	4,352	904
Asia	9,116	(1,548)	12,713	(593)
Japan	7,463	(1,755)	10,279	(351)
Other	2,334	66	2,855	(91)
Total All Countries	**$28,883**	**$(1,767)**	**$40,222**	**$1,324**

Source: U.S. Treasury

The U.K. stock market surprised investors in the first quarter, shooting up to the ranks of one of the best performing international markets. The 20% stock market runup translated into a gain of almost 30% in U.S. dollar terms, given the pound's advance on the dollar. U.S. investors were active participants in the U.K. market rally, boosting net purchases from $113 million in the last quarter of 1986 to $1.3 billion in the first quarter. Several factors enhance the attraction of U.K. investment: U.K. stocks have been labeled "cheap" in the global context, estimates of earnings growth have ranged as high as 20% for some U.K. companies, and the OECD has forecast comparably high 3% real economic growth for the U.K. in 1987.

In terms of other European investment, U.S. investors stepped up net selling of German stocks to $194 million in the first quarter from $46 million in the last quarter of 1986. The German stock market performed dismally in the first quarter, dropping some 15%. Among the factors weighting on the German market was the dimming prospects for export-related industries as the mark continued to appreciate and growth forecasts for trading partners came in at moderate. The Swiss market also lost ground in the first quarter, and U.S. investors made net sales of $33 million of Swiss stocks. On the other hand, U.S. investors increased portfolio holdings of Dutch and French stocks, making net purchases of $193 million and $40 million, respectively.

The reemergence of inflationary concerns prompted [illegible] U.S. investors to turn to commodity-related investment in the first quarter. Given the precious metal weighting of the Canadian stock market, U.S. investors stepped up net purchases to a significant $904 million in the first quarter. Driven by those investors seeking inflationary hedges and the attention of Japanese investors, the Canadian stock market literally boomed in the first quarter.

U.S. investors opted out of the Japanese stock market after the first half of 1986, with net sales of almost $3.0 billion made in the last half of the year. Total U.S. activity in Japanese stocks for 1986 resulted in net sales of $1.6 billion. While U.S. net selling moderated significantly in the first quarter of 1987 to $351 million, it is evident that the yen/dollar relationship, among other factors, kept U.S. investors on a cautious course. Nevertheless, in what is labeled a divergent performance between small and large capitalized companies, Japanese stocks rose by almost 20% in the first quarter. The gain reflected both Japanese savings and firms switching from capital to financial investment, the major force behind the market in 1986. Japanese institutions increased their equity investment by 125% in fiscal 1986, with domestic equity asset holdings increased by $90 billion.6/

Carolyn Hildebrandt
Assistant Vice President

6/"A crashing rise," The Economist, 4/25/87.

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Foreign Activity in U.S. Securities

"Highlights"

1. Although the U.S. stock market took its time in scoring a modest quarterly gain in the second quarter, foreign capital continued to flow into U.S. equities at a near-record pace. Second-quarter foreign net purchases of $8.6 billion take second place only to the first quarter's record $9.8 billion. For the first six months of 1987, foreign investors have added $18.4 billion to their portfolios, just 2% short of full-year 1986's record $18.7 billion. Japanese investors' net purchases amounted to $7.6 billion or 41% of the total through the first half of the year.

2. Foreign gross transactions in U.S. equities also continue to gain on last year's record. At the half-year mark, gross activity of $222.4 billion reached 80% of 1986's all-time high of $277.5 billion.

3. Not surprisingly, foreign net purchases of U.S. corporate bonds at half-year 1987 are running just 32% of 1986's $43.5 billion. Inflationary concerns and the dollar's slide have dampened foreign interest in this market. With the pullback of Japanese investors, foreign net purchases of corporate bonds fell 16% to $6.4 billion in the second quarter from $7.7 billion in the first.

4. Foreign investment in U.S. Treasuries in 1987 has increasingly reflected central bank intervention in the foreign exchange markets. Given dramatic revisions in Treasury's first-quarter data, foreign interest in the Treasury market in the first half of 1987 was comprised of $18.5 billion of central bank net purchases and $1.2 billion of net sales by the private sector.

5. U.S. investors maintained an interest in foreign stocks in the second quarter, albeit the magnitude of this interest was offset by large-scale sales of Japanese stocks. U.S. investors acquired $705 million of foreign stocks in the second quarter, boosting net acquisitions to $2.2 billion for the first six months of 1987.

Overview

Despite the uneven performance of the two primary factors determining foreign investment in U.S. equities, foreign capital flowed into U.S. stocks at a near-record pace in the second quarter. The hearty 20% gain of the U.S. stock market and a bit of short-lived dollar stability spurred foreign net investment in the first quarter to a high of $9.8 billion. However, in the second quarter, the stock market took some time to score a modest quarterly gain. A rise in U.S. interest rates helped the dollar reverse its downhill path. Nevertheless, foreign investors' enthusiasm for U.S. equities waned only moderately from the first-quarter level. At $8.6 billion, foreign net purchases of U.S. equities took second place only to the first quarter's record $9.8 billion. For the first six months of 1987, foreign net purchases of $18.4 billion fell just 2% short of full-year 1986's record $18.7 billion.

It was not until the last month of the second quarter that the U.S. stock market managed a gain of about 5%. April and May saw a market depressed by both inflationary and dollar concerns. There were some spurts and sputters in the market's performance. For example, in early May, the DJI Average took a one-day leap of over 50 points, which was subsequently erased by a one-day falloff of equal magnitude in mid-month when the bank prime rate was raised. In June, the market had a more optimistic picture to assess. Economic data for May soothed inflationary concerns and the dollar, supported by higher U.S. interest rates, continued its end-May advance against most major currencies. In a comparison with foreign stock markets, the U.S. market placed toward the lower end of the spectrum. However, markets worldwide suffered a notable slowdown in the second quarter. 1/

Whether by dint of the Paris Accord's stability pledge or higher U.S. interest rates, the dollar actually gained on most major currencies in the second quarter. As indicated by the $10.5 billion of Treasuries purchased by foreign central banks, market intervention to steady the dollar was heavy in the second quarter. In addition, policymakers commented frequently on measures under way to shore up the dollar. The dollar's second-quarter advance, however, was both minimal and temporary. Measured on an end-March to end-June basis, the dollar appreciated by 2% against the Canadian dollar, slightly over 1% against the German mark and French franc, and by less

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1/ Stock market comparisons in this report based on Morgan Stanley Capital International's market indices.

than 1% against the yen and Swiss franc. The dollar only lost ground against the British pound.

After a slow start, the U.S. stock market gained the momentum that eventually pushed the Dow past the 2500 mark in July. Encouraged by a stable dollar and relatively favorable economic news, the market ended July in a rally which saw the Dow hit four consecutive record days. Foreign investors continued to acquire U.S. equities, with SIA preliminary data putting net purchases at an estimated $2.0 billion.

Foreign Activity in U.S. Equities

Gross Activity

Foreign activity in U.S. equities in the second quarter subsided just a tad from the first-quarter record high of $113.0 billion. Second-quarter gross transactions came in at an impressive $109.4 billion, putting gross activity for the first six months of 1987 at $222.4 billion. Hence, at the halfway mark, the momentum of foreign transactions in U.S. equities was already 80% of 1986's record $277.5 billion.

The slack in the pace of gross transactions in the second quarter stemmed mainly from Latin America and the Caribbean. Latin American and Caribbean investors cut back activity by 10% to $11.0 billion. European and Canadian investors reduced gross transactions by around 3% each to $53.9 billion and $12.5 billion, respectively. Asian investors, mainly the Japanese, maintained a level of activity on par with the first quarter, $29.3 billion.

Net Purchases

Although remaining at an exceptional level, foreign net purchases of U.S. equities fell 13% in the second quarter to $8.6 billion from the record quarterly high of $9.8 billion in the first quarter. The increased attention paid to U.S. equities by Japanese investors tempered sharp reductions in net purchases by other major regions. Asian net purchases escalated by 21% to $4.4 billion. In contrast, European investors and Latin American and Caribbean investors reduced net purchases by over 30% to $3.2 billion and $660 million, respectively. Canadian investors slashed net purchases by 81% to $62 million. In total, net purchases by these three major regions were reduced 35%, on average, from the first-quarter level.

TABLE I

FOREIGN ACTIVITY IN
U.S. EQUITIES
($ Millions)

	First Quarter 1987		Second Quarter 1987	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$55,994	$4,682	$53,854	$3,174
Belgium-Luxembourg	2,625	180	3,048	130
France	4,541	1,242	4,133	562
Germany	3,785	97	3,786	(138)
Netherlands	2,027	213	2,995	476
Switzerland	15,306	379	13,551	451
United Kingdom	25,406	2,419	24,133	1,527
Canada	12,859	327	12,482	62
Latin America & Caribbean	12,144	1,011	10,956	660
Bermuda	2,943	(15)	2,520	(36)
Netherlands Antilles	4,516	491	3,344	(2)
Asia	29,272	3,616	29,254	4,390
Hong Kong	2,814	98	3,063	173
Japan	17,728	3,495	20,348	4,098
"Other Asia"*	7,262	(270)	4,152	(95)
Total All Countries	**$113,044**	**$9,833**	**$109,388**	**$8,592**

Source: U.S. Treasury
* Countries included are: Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, the United Arab Emirates.

European Investors

European net purchases of U.S. equities slid 32% to $3.2 billion in the second quarter from $4.7 billion in the first. The general European investment posture toward U.S. equities was mixed. Both French and U.K. investors reduced net activity from the heightened first-quarter levels. Investors located in the Belgium-Luxembourg countries also showed less interest in U.S. equities, while German investors swung to net sellers of $138 million. Only Dutch and Swiss investors stepped up net purchases in the second quarter.

The divergent performance of the U.S. and U.K. stock markets was one factor prompting a diminished U.K. enthusiasm for U.S. equities in the second quarter. Despite relatively favorable economic forecasts, the strong rise of the U.K. stock market in the first quarter surprised most observers. Contrary to most other major markets, the U.K. market continued to advance strongly in the second quarter, pausing along the way to consider election opinion polls. In addition, the pound held steady, even though most U.K. interest rates eased over the quarter. Both Mrs. Thatcher's victory and the lowering of rates were viewed as positives to the already strong outlook for the U.K. economy. In the second quarter, U.K. investors cut back net purchases of U.S. equities by 37% to $1.5 billion from $2.4 billion in the first quarter.

U.S. equity investment has had limited appeal to German investors in 1987. These investors made net purchases of $97 million in the first quarter and net sales of $138 million in the second quarter. After slumping in the first quarter, the German stock market made a moderate recovery in the second. Economic forecasts made early in the year have been sharply reduced as the strong mark has hampered growth for the one-third export dependent German economy. Stagnating export volumes and a sharp fall in export orders have put the German growth rate at no more than 1.5% in 1987, a pace that is seen as having little potential to reduce Germany's 9% unemployment rate.2/ Nevertheless, German investors may have turned to their home markets which reportedly offered better value than the U.S. stock market and other major European markets.

Although halting its first-quarter slide, the Swiss market failed to record even a 1% gain over the second quarter. Swiss investors continued to make relatively large net purchases of U.S. equities, boosting acquisitions by 19% to $451 million from $379 million. In contrast, adverse economic forecasts, particularly the threat of a trade deficit on the horizon, took their toll on the French stock market in the second quarter. The French market gave up 10% over the quarter, pushing the market to last place in the global performance rankings. However, French investors slashed net purchases of U.S. equities by 55% to $562 million from an extraordinary $1.2 billion in the first quarter.

Canadian Investors

In the second quarter, the Canadian market was not able to repeat its stellar first-quarter performance. Canadian interest rates followed U.S. rates in the second quarter, with the increase keeping the Canadian dollar steady while threatening to exacerbate existing economic problems. The rise

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2/"Storm clouds on the horizon", Financial Times, 7/16/87.

in Canadian rates, particularly for short-term maturities, outpaced the increase in U.S. rates, significantly widening the differential favoring Canadian issues. For example, the spread between three-month money market instruments widened from 30 basis points at the end of May to 135 basis points by the end of June. Canadian investors may have focused on domestic fixed income instruments, as they reduced net purchases of U.S. equities by 81% to $62 million from $327 million in the first quarter.

Latin American & Caribbean Investors

Interest in acquiring U.S. equities stemming from the Latin American and Caribbean region dropped 35% to $660 million in the second quarter from $1.0 billion in the first. The rumors and chaos surrounding the announcement of the cancellation of the U.S.-Netherlands Antilles treaty, which came at the end of the second quarter, may have cast a pall on all U.S. corporate securities investment. Net transactions stemming from the Netherlands Antilles resulted in sales of $2 million of U.S. equities, compared with net purchases of $491 million in the first quarter. Four other countries in this region (not shown in Table I) were net purchasers of over $100 million each of U.S. equities.

Asian Investors

In the second quarter, Asian net purchases of U.S. equities increased 21% to $4.4 billion from $3.6 billion. Japanese investors have come to dominate activity from the Asian region. Indeed, the escalation of Japanese net acquisitions of U.S. equities in the second quarter to $4.1 billion made Japanese investors the major foreign players in the U.S. equity market. Second-quarter net purchases by these investors measured 29% more than that of all European investors and almost half of total foreign net purchases.

The build-up of Japanese interest in U.S. equities parallels both a disenchantment with U.S. fixed income markets and a report d disenchantment with domestic markets. Japanese investors shied away from U.S. corporate bond investment in the second quarter, and Treasury investment may well reflect central bank activity. The May-June strengthening of the dollar vis-á-vis the yen coupled with sagging domestic bond and stock markets caused a reported acceleration of net capital outflow from Japan.3/ Part of this outflow found its way to the U.S. equity markets, pushing Japanese net acquisitions to $7.6 billion for the first six months of 1987.

3/"Cash mountain builds up in Japan," Financial Times, 7/23/87.

TABLE II

FOREIGN ACTIVITY IN
U.S. CORPORATE BONDS
($ Millions)

	First Quarter 1987		Second Quarter 1987	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$18,300	$6,176	$24,363	$6,179
Belgium-Luxembourg	501	(174)	516	(39)
France	613	98	597	33
Germany	1,381	117	1,177	(83)
Switzerland	1,788	724	1,572	352
United Kingdom	13,096	5,300	19,569	5,721
Asia	4,974	1,090	4,594	(480)
Japan	3,775	1,059	3,171	(423)
"Other Asia"	523	(43)	824	3
Total All Countries	**$25,726**	**$7,698**	**$31,571**	**$6,429**

Source: U.S. Treasury

Foreign Activity in U.S. Corporate Bonds

Not surprisingly, foreign investor interest in U.S. corporate bonds has been at a comparably low level in the first six months of 1987. Second-quarter net purchases came in at $6.4 billion, a 16% drop from first-quarter net acquisitions of $7.7 billion. For the first half of the year, foreign acquisition of corporate bonds, $14.1 billion, are running only 32% of 1986's $43.5 billion. Inflationary worries and the dollar's slide are two factors making foreign investors wary of U.S. corporate bonds. In the second quarter, despite a particularly turbulent April for the dollar, the 95 basis point sprint in corporate bond yields to 9.60% elicited considerable interest from foreign investors, with net purchases reaching $3.3 billion.[4/] Although the dollar steadied and yields

[4/] Yield comparisons in this report based on data in World Financial Markets, Morgan Guaranty Trust Co.

remained at the April level for the rest of the quarter, foreign investors turned cautious. Net purchases in May and June together only equalled the April figure.

European net purchases of corporate bonds in the second quarter matched first-quarter activity, $6.2 billion. Once again, U.K. investors provided the support for European activity as most of the major countries shunned additional U.S. corporate bond investment. With the jump in U.S. corporate bond yields in April, the yield spread favoring U.K. issues narrowed sharply, from 156 basis points at end-March to 60 basis points by end-June. Nevertheless, U.K. net acquisition of corporate bonds increased by 8% to $5.7 billion from $5.3 billion in the first quarter. Even at this pace, however, U.K. enthusiasm has waned considerably from the 1986 level, when quarterly net purchases averaged $8.2 billion.

In contrast, U.S. corporate bonds held no attraction for Japanese investors. After purchasing $1.1 billion in the first quarter, these investors swung to net sellers of $423 million in the second. This represents the first quarter that Japanese disillusionment with U.S. corporate bonds has shown up in the data. Much has been made of the Japanese departure from the U.S. Treasury market and the same currency/yield considerations seem to have been extended to the corporate bond market in the second quarter. While Japanese investors have deserted U.S. fixed income investments, they have funneled their capital into the U.S. equity markets.

Foreign Activity in U.S. Treasuries

Foreign investment in U.S. Treasuries this year has increasingly reflected central bank intervention in foreign exchange markets. This trend, which started in the latter half of 1986, has gained momentum in the first six months of 1987, corresponding with increased worldwide concern about the plight of the dollar. Given dramatic revisions in Treasury's first quarter data, foreign activity in the first half of 1987 was comprised of $18.5 billion of central bank net purchases and $1.2 billion of net sales by private foreigners and institutions. International and regional organizations were also net sellers of about $2.0 billion. Hence, in 1987, it took central bank net purchases to prop up the dollar to actually offset net selling of Treasuries by the private foreign sector. This stands in sharp contrast to 1985 when private foreigners and institutions acquired over $20 billion of Treasuries. In 1986, these investors acquired only $6.8 billion of Treasuries, while central banks acquired $14.4 billion.

Activity in the second quarter reflected the dollar's woes, particularly in April, and central banks' pledge via the Paris Accord to attempt to stabilize currency markets. Foreign official institutions purchased a significant $10.5 billion of Treasuries, compared with $8.1 billion in the first quarter. The private foreign sector showed interest in Treasuries only in the last month of the quarter, when both firm U.S. interest rates and foreign central bank action steadied the dollar. Concerns over inflationary pressures were also dampened in June by favorable economic data. Yields on U.S. Treasuries rose 64 basis points in April to 8.45% and stayed close to this mark for the remainder of the second quarter. Foreign net purchases of Treasuries summed to $8.6 billion in the second quarter, compared with $6.7 billion (revised) in the first.

With the exception of the reversal of the U.K. position on Treasuries, activity stemming from the major European countries in the second quarter almost mirrors the first. The pound was the only major European currency which gained, very minimally,

TABLE III

FOREIGN ACTIVITY IN
U.S. TREASURY NOTES AND BONDS
($ Millions)

	Full Year 1986 Net Purchases	First Quarter 1987 Net Purchases	Second Quarter 1987 Net Purchases
Europe	$16,866	$8,959	$5,444
Switzerland	310	1,979	1,701
West Germany	7,531	3,840	3,797
United Kingdom	4,648	1,540	(1,031)
Asia	1,341	(2,068)	2,825
Japan	(77)	(766)	1,081
"Other Asia"	(1,473)	(1,456)	(341)
Nonmonetray Int'l & Regional Organizations	(1,103)	172	(2,179)
Total All Countries	**$20,061**	**$6,742**	**$8,575**

Source: U.S. Treasury
Note: Treasury has made extensive revisions in 1986 and first-quarter 1987 data. We have incorporated these revisions in the Table.

to the dollar on a quarterly basis. U.K. transactions resulted in net sales of $1.0 billion of Treasuries, compared with net purchases of $1.5 billion in the first. Hence, U.K. net sales precipitated the drop in European net purchases to $5.4 billion from $9.0 billion in the first quarter.

On the other hand, activity stemming from the Asian region shows a swing from net sales of $2.1 billion of Treasuries to net purchases of $2.8 billion. First-quarter net sales resulted mainly from heavy net divestitures, $1.5 billion, by the oil-exporting countries. The second-quarter figure rests primarily on Japanese net purchases, $1.1 billion, and unusually high acquisitions of $2.0 billion from Taiwan (not shown in Table III). Two factors could account for the positive Japanese position: central bank intervention or the rumored "jawboning" of Japanese policy officials which urged Japanese institutions to step up purchases of U.S. governments.

U.S. Investor Activity in Foreign Stocks

With the surge of stock markets worldwide in the first quarter of 1987, U.S. investor interest in foreign stocks also surged. A heightened interest in foreign stocks continued in the second quarter of the year, albeit the magnitude of this interest was mitigated by large-scale sales of Japanese stocks. U.S. investors acquired $705 million of foreign stocks in the second quarter, compared with $1.5 billion (revised) in the first. At the half-year point, U.S. net purchases of foreign stocks amounted to $2.2 billion, a shade more than 1986 net purchases of $1.9 billion.

Gross activity continued at a dramatic pace, underscoring U.S. participation in foreign markets. In 1986, gross transactions reached a record $99.5 billion (revised), more than twice the prior year's high. While past patterns indicate that activity tends to hit a plateau at which it remains for several years before escalating again, the rate of 1987's gross transactions augurs for another peak year. For the first six months of 1987, U.S. gross activity in foreign stocks measured $88.2 billion, some 89% of 1986's high.

With the 20% rise of the Japanese stock market in the first quarter, U.S. investors moderated the net selling of Japanese stocks which began in the third quarter of 1986. However, in the second quarter, trade friction between the U.S. and Japan heated up and the Japanese stock market rose by a notably volatile 7%. U.S. investors stepped up net sales of Japanese stocks to $2.0 billion, the largest amount in the four-quarter net sale period. Adding fuel to the second-quarter net

divestiture posture was the call by many forecasters for a major correction in the large capitalized stocks driving the Tokyo market's rise and a relatively weak growth outlook for the Japanese economy.

On the other hand, U.S. investors turned more bullish about European stocks in the second quarter. Net purchases were increased 76% to $1.9 billion from $1.1 billion in the first, representing the highest quarterly level in a year and a half. U.S. interest in foreign stocks was strongest in April. In that month, appreciating currencies and rising markets translated into gains greater than could be found in the languishing U.S. market. Indeed, monthly data show that after April's buying spree, U.S. investors' enthusiasm subsided as the U.S. dollar started to gain and the runup of European stock markets started to slow.

TABLE IV

U.S. INVESTORS' ACTIVITY IN FOREIGN STOCKS
($ Millions)

	First Quarter 1987		Second Quarter 1987	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$20,302	$1,104	$25,691	$1,941
France	1,396	40	1,408	4
Germany	2,070	(194)	2,773	203
Netherlands	1,055	193	1,493	281
Switzerland	1,307	(33)	1,503	157
United Kingdom	12,989	1,277	16,626	888
Canada	4,352	904	4,530	696
Asia	12,713	(593)	15,016	(2,190)
Japan	10,279	(351)	12,848	(2,004)
Other	2,855	(91)	3,276	258
Total All Countries	**$39,664**	**$1,473**	**$48,513**	**$705**

Source: U.S. Treasury
Note: Total all countries data for the first quarter are revised. Country data unrevised.

The U.K. market was among the top five best performing markets in the first quarter of the year, and little of its steam was lost in the second quarter. U.S. interest in U.K. stocks was maintained at an unusually high level, although net purchases were reduced from the first-quarter level. Net purchases were cut back 30% to $888 million in the second quarter from $1.3 billion in the first. U.S. investors continued to shy away from French stocks, making net purchases of $4 million in the second quarter compared with $40 million in the first. The French stock market took a 10% step backwards in the second quarter. Disturbing economic news, including a deteriorating trade deficit and slipping GNP growth, weighed heavily on the investment picture. These factors reportedly have caused both foreign institutions to sell their French shares and French investors to become wary.5/

In contrast, certain European markets that were laggards in the first quarter recovered somewhat in the second quarter. Improved market performance and a bit of bargain hunting may account for the increased attention paid to German and Swiss stocks. U.S. investors swung from net sellers of $194 million and $33 million of German and Swiss stocks in the first quarter to net purchasers of $203 million and $157 million, respectively. While the Dutch market was not sluggish in the first quarter, upward pressure on oil-prices gave a boost to the oil and gas sector of the Dutch market. U.S. investors increased net purchases of stocks of companies located in the Netherlands by 46% to $281 million from $193 million in the first quarter.

After soaring in the first quarter, the Canadian market's climb stalled in the second as Canadian interest rates leaped forward following U.S. rates. Nevertheless, although U.S. investors reduced net purchases by 23% to $696 million in the second quarter, this level still represents a high degree of interest in Canadian stocks. Inflationary concerns could have accounted for U.S. investors' continued interest in Canadian commodity-related investment.

Carolyn Hildebrandt
Assistant Vice President

5/"Is It Finis for the Bourse's Boom?", Barron's, 7/29/87.